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Murphy v. Internal Revenue Service, the Meaning of Income, and Sky-is-Falling Tax Commentary

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MURPHY V. INTERNAL REVENUE SERVICE, THE MEANING OF “INCOME,” AND SKY-IS-FALLING TAX COMMENTARY

Erik M. Jensen[†]

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I. INTRODUCTION

Politics constrains the federal taxing power, of course: a candidate's promise to raise taxes across the board is generally thought to be political suicide, as is breaching a promise not to raise taxes. The conventional wisdom, however, is that the Constitution imposes no significant *legal* limitations on the taxing power.¹ If Congress is willing to take the political flack, it can do what it wants, or so it is assumed. Similarly, in construing what Congress has done on a tax issue, a court can usually proceed without meaningful references to the Constitution.

¹ The Constitution imposes real restrictions in special situations. For example, the Export Clause provides that "No Tax or Duty shall be laid on Articles exported from any State," U.S. CONST. art. I, § 9, cl. 5, and that Clause has been enforced. *See United States v. U.S. Shoe Corp.*, 523 U.S. 360, 366–70 (1998) (holding that the Harbor Maintenance Tax, which obligates exporters to pay a percentage of the value of cargo shipped, was a tax on exports and therefore unconstitutional); *United States v. Int'l Bus. Machs. Corp.*, 517 U.S. 843, 861–62 (1996) (holding that the Export Clause categorically bars Congress from imposing any tax on exports); *see also Erik M. Jensen, The Export Clause*, 6 FLA. TAX REV. 1 (2003) (detailing the historical importance of the Export Clause and observing that, although the Export Clause is enforced by modern courts, its effect is largely invisible in the lives of ordinary Americans).

In the widely noted case of *Murphy v. Internal Revenue Service*,² a panel of the United States Court of Appeals for the District of Columbia Circuit ultimately reached a result consistent with conventional wisdom, concluding that a whistleblower's recovery for emotional distress was properly includable in the income-tax base.³ But the court followed a torturous path to get there, and *Murphy* provides an opportunity to revisit some basics of taxation. At bottom one of the questions in *Murphy* was "What is income?" and you cannot get more basic than that.

A. *Murphy I and the Hyperventilating Blogosphere*

Chief Judge Douglas Ginsburg's opinion on *Murphy*'s first go-round in August 2006 (*Murphy I*), which unanimously concluded that the emotional-distress recovery was not income within the meaning of the Sixteenth Amendment and, as a result, could not be reached by the federal income tax,⁴ characterized the government's arguments as resting on a "breathtakingly expansive claim of congressional power."⁵ Although the panel must have known that striking down an exercise of the taxing power would be noteworthy, it apparently did not realize how controversial its conclusion would be.

Murphy I did not have a long shelf life; the negative reaction was immediate—the decision "shocked the tax community"⁶—and effective. Tax professors generally were appalled (some refusing to read the opinion, or so they said, because the result was so bizarre), and cries were heard that the decision was not only dumb but also catastrophic.⁷ If an emotional-distress recovery were not income, then logically, it was argued, wages were not either. Remove compensation for services from the income-tax base, and the base would be gutted.

² 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

³ *Id.* at 171.

⁴ *Murphy v. IRS (Murphy I)*, 60 F.3d 79 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006). The panel included two Republican appointees and one Democratic. If this decision had partisan political overtones, they were not obvious.

⁵ *Id.* at 87. The breathtaking claim was that *any* receipt of value could be reached: "The Sixteenth Amendment simply does not authorize the Congress to tax as 'incomes' every sort of revenue a taxpayer may receive. As the Supreme Court noted long ago, the 'Congress cannot make a thing income which is not so in fact.'" *Id.* (quoting *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925)).

⁶ Joseph M. Dodge, *Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards*, 8 FLA. TAX REV. 369, 370 (2007) [hereinafter Dodge, *Murphy and the Sixteenth Amendment*].

⁷ See, e.g., Marcia Coyle, *Full Court May Weigh Taxation of Damages*, NAT'L L.J., Oct. 30, 2006, at 1 (quoting officials and commentators, one of whom called *Murphy I* "outrageous").

Obviously embarrassed by the reaction—according to Professor Paul Caron, the court was “prodded by the tax blogosphere”⁸—the panel on its own motion vacated its judgment in December 2006.⁹ New briefs were filed, the case was reargued, and in June 2007 the same panel unanimously held, on the basis of an issue “belatedly raised” and “newly argued”—the court was covering its backside—that the recovery had been properly taxed.¹⁰

The panel’s abrupt turnaround left rubber on the road. With the decision in *Murphy II*, most of the tax professoriate and the tax bar gave a sigh of relief. And when the Supreme Court denied certiorari in April 2008,¹¹ the Republic appeared safe.

Or maybe not. Not all critics were mollified. For example, Professor Caron has written that “the panel could not unring the bell and undo much of the damage caused by its original decision.”¹² By ignoring the Supreme Court’s good sense in *Commissioner v. Glenshaw Glass Co.*¹³—which, half a century earlier, had “appeared to establish the term ‘gross income’ as a catch-all phrase reaching all accessions to wealth, regardless of source”¹⁴—the panel “turned what should have been a run of the mill tax dispute . . . into a threat to the very survival of the income tax.”¹⁵ Strong stuff. *Murphy I* might have no legal effect, but Caron and others worried that it encouraged tax protesters.¹⁶ Moreover, since the opinion had been printed in the

⁸ Paul L. Caron, *The Story of Murphy: A New Front in the War on the Income Tax*, in TAX STORIES 55, 91 (Paul L. Caron ed., 2d ed. 2009). Caron presents instant analysis from the post-*Murphy I* period, see *id.* at 70–71, and makes the case for blogs’ centrality in modern tax policy. See *id.* at 90–91.

⁹ See *Murphy v. IRS*, No. 05-5139, 2006 WL 4005276, at *1 (D.C. Cir. Dec. 22, 2006). A petition for rehearing en banc had been filed. The panel vacated the judgment before the petition was acted upon, but the panel relied in part on the argument in the petition. See *Murphy v. IRS (Murphy II)*, 493 F.3d 170, 173 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

¹⁰ *Murphy II*, 493 F.3d at 173.

¹¹ *Murphy v. IRS*, 553 U.S. 1004 (2008). Had the panel reaffirmed its original decision and had the full court accepted that conclusion, the Supreme Court might have granted cert. As it was, the result was mundane.

¹² Caron, *supra* note 8, at 56.

¹³ 348 U.S. 426 (1955).

¹⁴ Caron, *supra* note 8, at 55. In fact, *Glenshaw Glass* did not say a personal injury recovery is an “accession to wealth.” The Court distinguished taxable punitives, which “cannot be considered a restoration of capital for taxation purposes,” from “[d]amages for personal injury [which] are . . . compensatory only.” *Glenshaw Glass*, 348 U.S. at 432 n.8. By implying that such recoveries might be nontaxable, the Court contributed to the confusion Caron blamed on *Murphy I*. See *infra* notes 68–79 and accompanying text.

¹⁵ Caron, *supra* note 8, at 91.

¹⁶ I have been accused of that too, because of an article that antedated *Murphy*. See Joseph M. Dodge, Letter to the Editor, *Jensen’s Missiles Don’t Get Off the Ground*, 107 TAX NOTES 131, 132 (2005) [hereinafter Dodge, *Jensen’s Missiles*] (accusing me of taking “dangerous” positions and evidencing “sympathy with tax protesters” in arguing that not all recoveries for nonphysical personal injuries are taxable).

Federal Reporter, it can cause mischief for eternity.¹⁷

Phooey. I agree with James Reardon that “[t]he scholars and commentators should lighten up a bit.”¹⁸ Although *Murphy I* contained an amazing number of howlers, and deserved criticism, the result was defensible. It was not clearly right, but it was not clearly wrong either, particularly if the purposes behind the Sixteenth Amendment matter. It is hard to prove what was in peoples’ minds in the early twentieth century, but I have no doubt that Amendment proponents would have been horrified to think an emotional-distress recovery might be “income.”¹⁹ Most people outside the academy would be horrified at that idea today.²⁰ Indeed, I will go further than the panel did: all or part of the recovery, which was assumed to have no replacement-of-earnings component,²¹ might not even have been “gross income” within the

¹⁷ Even if not printed—hard copy no longer guarantees availability for eternity—the opinion would have survived electronically. The vacated opinion is available on the D.C. Circuit’s Web site. See *Murphy v. IRS (Murphy I)*, No. 05-5139 (D.C. Cir. Aug. 22, 2006), available at <http://pacer.cadc.uscourts.gov/docs/common/opinions/200608/05-5139a.pdf>.

¹⁸ James D. Reardon, *Marrita Murphy: The Flip Side of the Economic Substance Doctrine*, 112 TAX NOTES 1167, 1170 (2006); see also Robert W. Wood, Letter to the Editor, *Wood Looks at the Flip Side of Murphy v. IRS*, 113 TAX NOTES 188, 188 (2006) (“I am tired of endless potshots at *Murphy* . . .”). A student or two supported *Murphy I*, see, e.g., Russell F. Romond, Note, *Income, Taxes and the Constitution: Why the D.C. Court of Appeals Got It Right in Murphy*, 12 FORDHAM J. CORP. & FIN. L. 587 (2007), but what do they know?

¹⁹ Cf. *Merchs.’ Loan & Trust Co. v. Smietanka*, 255 U.S. 509, 519 (1921) (“In determining the definition of . . . ‘income’ . . . this court has . . . refused to enter into the refinements of lexicographers or economists and has approved, . . . what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment . . .”). For additional discussion of this point, see Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of “Incomes,”* 33 ARIZ. ST. L.J. 1057 (2001) [hereinafter Jensen, *Meaning of Incomes*] (discussing the Amendment in enough detail to cause emotional distress).

²⁰ Cf. Philip Mullock, *The Constitutional Problem of Taxing Gifts as Income*, 53 MINN. L. REV. 247, 254 (1968) (questioning whether gifts could be included in income-tax base); Steven T. O’Hara, *Thinking Outside the Code*, 116 TAX NOTES 679 (2007) (discussing the different meanings of “income” and urging consideration of such issues). The physical-nonphysical distinction of income has been challenged on policy grounds. See, e.g., Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447 (1998); Vivian Berger, *End the Inequity*, NAT’L L.J., Sept. 17, 2007, at 23. Although he signed the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755, President Clinton disapproved of taxing personal injury recoveries, which “are designed to make victims whole, not enrich them.” Statement on Signing the Small Business Job Protection Act of 1996, 2 PUB. PAPERS 1317, 1318 (Aug. 20, 1996). Professor Hubbard has challenged the distinction on constitutional grounds. See F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725 (1997). But see Douglas A. Kahn, *The Constitutionality of Taxing Compensatory Damages for Mental Distress When There Was No Accompanying Physical Injury*, 4 FLA. TAX REV. 128, 129 (1999) (arguing this distinction raises no constitutional problem).

²¹ *Murphy I*, 460 F.3d at 81 (noting that “compensation for a non-physical personal injury is not income under the Sixteenth Amendment if, as here, it is unrelated to lost wages or earnings”).

meaning of section 61 of the Internal Revenue Code.

Most important, I shall argue that, if *Murphy I* had survived, it would not have done irreparable damage to the income tax or the tax system as a whole. The narrow issue—taxation of emotional-distress recoveries—has no significant revenue effects.²² The decision would have stood only for the proposition that ratifiers of the Sixteenth Amendment did not think Congress can characterize *anything* as income (and maybe also that Congress, in defining “gross income,” did not intend to pick up all receipts of value). Concluding that “income” is not an empty vessel into which any content can be poured is not revolutionary; it takes language seriously.²³

The idea that tax protesters gained traction from *Murphy I* was especially overdone in the commentary. Protesters need no encouragement to see systemic flaws. And, if encouragement to frivolousness developed, it came more from critics than from the *Murphy I* opinion.²⁴ It was the critics who said *Murphy I* might mean that wages (and other clearly taxable items) are not income.²⁵ Wages and emotional-distress recoveries are not the same,²⁶ and, in any event, no one can seriously argue that wages are off-limits in the income tax.²⁷ *Murphy I* might have been problematic, but hyperbole

²² Cf. Caron, *supra* note 8, at 91 (“Although questions about the taxation of damage recoveries will not bring down the income tax, the willingness of so many to shake its foundations may ultimately prove its undoing.”).

²³ In criticizing *Murphy I*, Professor Theodore Seto argued that “[t]he single most problematic aspect of constitutionalizing the definition of income is that doing so threatens to deprive Congress of the flexibility needed to make a tax system work.” Theodore Seto, *Bank of America as an Alternative to Originalism in Murphy*, http://taxprof.typepad.com/taxprof_blog/2006/08/seto_bank_of_am.html (Aug. 28, 2006), *quoted in* Caron, *supra* note 8, at 71. Constitutions are supposed to limit flexibility, and I am bewildered that we should not “constitutionalize” a term in the Constitution.

²⁴ Vacated opinions give no penalty protection. Cf. *Suder v. Comm’r*, No. 3245-06S, T.C. Summ. Op. 2008-97, at 1-2 (Aug. 7, 2008), *available at* <http://www.ustaxcourt.gov/InOp/Historic/suder.sum.WPD.pdf> (“Pursuant to [Internal Revenue Code] section 7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.”).

²⁵ See, e.g., Caron, *supra* note 8, at 78-79 (recapitulating a number of critics’ concerns that *Murphy I* would lead to the end of the income tax). The notion that a protester would connect emotional-distress recoveries and wages is far-fetched. He would need help: “Hey, Bud, did you see what that Big State tax prof said? A new case says Uncle Sam can’t tax our salaries. Sounds right to me.”

²⁶ See *infra* Part V.I.E.

²⁷ “Compensation for services” is listed in Code section 61(a)(1). See I.R.C. § 61(a)(1) (2006). The Sixteenth Amendment was not directed at wage-earners, but compensation was understood to be part of the tax base. See Wilson-Gorman Tariff Act of 1894, ch. 349, § 27, 28 Stat. 509, 553 (reaching “gains, profits or income” above \$4,000, “whether said gains, profits, or income be derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation . . . or from any other source”); Revenue Act of 1862, ch. 119, §§ 89-93, 12 Stat. 432, 473-75 (imposing a 3% tax on “annual gains, profits, or income of every person residing in the United States” above \$600, with a 5% rate applicable to amounts over \$10,000); see also *Springer v. United States*, 102 U.S. 586 (1881) (approving

seems to overwhelm common sense in discussions like this.²⁸

Finally, I shall argue, *Murphy II* contained its own complement of questionable propositions—questionable partly because they are inconsistent with prior authority. For one thing, the D.C. Circuit advanced a conception of the relationship between the meaning of “incomes” in the Sixteenth Amendment and the meaning of “income” in the Internal Revenue Code that was contrary to decades of Supreme Court authority.

As a matter of first principle, it is not absurd to think that the statutory definition of “income” can include items that are not income under the Amendment as long as other constitutional authority supports taxation.²⁹ But the Court has many times said the two documents should be interpreted consistently.³⁰ (Indeed, Judge Ginsburg in *Murphy I* noted that “[t]he Supreme Court has held that the word ‘incomes’ in the Amendment and the phrase ‘gross income’ in § 61(a) of the IRC are coextensive.”³¹) In *Murphy II*, however, the D.C. Circuit concluded that the whistleblower’s recovery could constitutionally be reached by section 61 regardless of whether it was “income” under the Amendment.³² In addition, the panel concluded the recovery could be taxed even though it might not have been

unapportioned 1862 income tax). *But see* *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, 158 U.S. 601 (1895) (striking down unapportioned 1894 income tax).

²⁸ Responding to an article in which I argued that recoveries for nonphysical injuries are not automatically taxable, a critic accused me of “giving aid and comfort to tax protestors who claim that wages are not income under section 61.” Joseph M. Dodge, Letter to the Editor, *Of Course Recoveries for Nonphysical Injuries are Taxable!*, 106 TAX NOTES 986, 987 (2005) [hereinafter Dodge, *Recoveries for Nonphysical Injuries*] (responding to Erik M. Jensen, *Are Recoveries for Nonphysical Injuries Automatically Taxable?*, 105 TAX NOTES 1439 (2004) [hereinafter Jensen, *Automatically Taxable?*]).

²⁹ See Gregory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis of Murphy v. Internal Revenue Service*, 60 ARK. L. REV. 185, 191 (2007) (“It is . . . possible for Ms. Murphy’s award to constitute ‘income’ under the I.R.C., but not . . . under the Sixteenth Amendment, for the I.R.C. has an evolving meaning changeable by Congress . . .”).

³⁰ It had always been understood that Congress might exercise less than full power, by exempting items that could be taxed. In that respect, the statutory definition of “gross income” could be narrower than the constitutional meaning of “incomes.” The possibility that the statutory definition might be broader had been hypothesized, but, until *Murphy II*, it had not been accepted. See Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 6, at 376 (“[N]o court (including the *Murphy II* panel decision) has . . . taken such a view, and so it must be viewed as being only a remote theoretical possibility.”). The remote possibility soon became real.

³¹ *Murphy I*, 460 F.3d 79, 85 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006) (citing, *inter alia*, *Helvering v. Clifford*, 309 U.S. 331, 334 (1940)). Moreover, the term generally should be understood in a nontechnical way. See *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99 (1936) (“Income within the meaning of the Sixteenth Amendment is[,] . . . [w]ith few exceptions, if any, . . . income as the word is known in the common speech of men.”).

³² *Murphy II*, 493 F.3d 170, 179 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

considered “gross income” historically and even though Congress had not explicitly amended section 61 to expand its scope.³³

Taxation is hard enough to understand without the meaning of “income” shifting from one setting to another, and, if the cash received by Ms. Murphy was not “income” under the Sixteenth Amendment—*Murphy II* did not repudiate that part of *Murphy I*—what was the effect of imposing a tax on the recovery? The *Murphy II* panel said the levy was an “excise,”³⁴ but it looks a lot like a tax on wealth. If so, to be constitutional, it should have been subject to the onerous direct-tax apportionment rule.³⁵ Never before had a court hinted that an unapportioned national tax on wealth, if packaged in the right way, might meet constitutional requirements. In its haste to correct mistakes in *Murphy I*—and to be applauded by the legal academy—the panel in *Murphy II* took positions that are harder to defend than *Murphy I*.

B. The Plan of Attack

The *Murphy* litigation is done, but the issues should not go away. They are important, interesting, and even fun. In making the case for their significance, I shall proceed as follows. Part II sets out the facts and procedural posture of *Murphy I*, and, to help us feel superior to the D.C. Circuit, Part III describes some of the howlers in that decision.

The next two parts of the Article examine the issues that made *Murphy* a more difficult case than most commentators think and that made the result, if not the reasoning, of *Murphy I* defensible. Part IV discusses the constitutional structure—the direct-tax clauses and the Sixteenth Amendment—and explains why the constitutional issues in *Murphy* were serious. Part V considers the role of section 104(a)(2) in analyzing recoveries for nonphysical personal injuries, concluding that not all such recoveries are fully taxable.

Part VI argues that treating recoveries in a personal setting like *Murphy* differently from receipts of value in a business or investment context is not silly. Finally, Part VII considers *Murphy II*'s change of direction, questions the desirability of having the meaning of “gross

³³ *Id.* at 180.

³⁴ *Id.* at 186. An excise must satisfy only the uniformity rule, U.S. CONST. art. I, § 8, cl. 1 (“[A]ll Duties, Imposts and Excises shall be uniform throughout the United States.”); *see also Murphy II*, 493 F.3d at 184–86 (stating that an excise tax does not need to satisfy the more stringent apportionment rule).

³⁵ *See Murphy II*, 493 F.3d at 184–86 (noting that the apportionment rule is applicable to a direct tax that is not a tax on incomes); *see also infra* Part IV (discussing taxation of nonphysical personal injuries).

income” unmoored from the constitutional meaning of “incomes,” and explains why the case bizarrely supports an unapportioned tax on wealth.

II. MURPHY I: THE BASICS

In 1994, Marrita Murphy complained to the United States Department of Labor that a former employer, the New York Air National Guard, had violated whistleblower statutes by blacklisting her and providing unfavorable references after she had alerted environmental authorities to some of the Guard’s suspect activities.³⁶ The Labor Department determined that unlawful retaliation had in fact occurred, and an administrative law judge concluded that Murphy had suffered \$70,000 in damages—\$45,000 attributable to “emotional distress or mental anguish” and \$25,000 to “injury to professional reputation”—which she received in 2000.³⁷

Although one might think that “injury to professional reputation” relates to future earning power, the D.C. Circuit specifically stated that “[n]one of the award was for lost wages or diminished earning capacity.”³⁸ If the injury was nonphysical and the recovery was only for lost earnings, no authority would have supported excluding the recovery from gross income. But the litigation proceeded with a different assumption about the reasons for Murphy’s compensation.³⁹

Murphy initially paid federal income taxes on the recovery, but she later filed an amended return, taking the position that, under Internal Revenue Code section 104(a)(2), the \$70,000 was not taxable.⁴⁰ That section had historically provided an exclusion from gross income for a recovery “received on account of personal injuries or sickness,”⁴¹ but, in 1996, Congress amended the section to limit the exclusion to recoveries for “personal physical injuries or physical sickness” and to provide that “emotional distress shall not be treated as a physical injury or physical sickness.”⁴² The amended version of section 104(a)(2) applied to Murphy’s award.⁴³

³⁶ At the time her name was Leveille, but, like the D.C. Circuit, I will refer to her as “Murphy” throughout the Article. See *Murphy I*, 460 F.3d at 81.

³⁷ *Id.* (internal quotation marks omitted).

³⁸ *Id.*

³⁹ I am not sure the district court would have agreed with the D.C. Circuit’s characterization of the award, but the district court’s resolution of the case made that point irrelevant. See *Murphy v. IRS*, 362 F. Supp. 2d 206 (D.D.C. 2005), *rev’d*, 460 F.3d 79 (D.C. Cir. 2006), *aff’d on reh’g*, 493 F.3d 170 (D.C. Cir. 2007), *cert.denied*, 553 U.S. 1004 (2008).

⁴⁰ See *Murphy I*, 460 F.3d at 81.

⁴¹ I.R.C. § 104(a)(2) (1994).

⁴² Small Business Job Protection Act of 1996, Pub. L. No. 104-88, §§ 1605(a), 1605(b), 110 Stat. 1755, 1838 (amending I.R.C. §§ 104(a)(2) and 104(a)).

⁴³ See *Murphy II*, 493 F.3d 170, 171 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008);

Once the dispute reached litigation, Murphy argued in the alternative that she had suffered a physical injury (“bruxism” or teeth grinding) from the harassment or, if her injury was not physical, that her recovery was not income within the meaning of the Sixteenth Amendment.⁴⁴ The district court granted the government’s motion for summary judgment on both issues.⁴⁵

The determination that Murphy’s injury was not physical for purposes of the statutory exclusion—affirmed by the D.C. Circuit⁴⁶—itself raises interesting questions,⁴⁷ but I shall focus only on the alternative claim.⁴⁸ The D.C. Circuit panel determined that the recovery, although for a nonphysical injury and thus not excluded by section 104(a)(2), was not “income” as a matter of constitutional law.⁴⁹ Applying the “in lieu of” test—what did the recovery replace?—the panel concluded that no part of the recovery compensated for anything that would have been taxable, like lost wages.⁵⁰ Had the recovery been “in lieu of” otherwise taxable income, it would have been “income” under the Sixteenth Amendment.⁵¹ But the panel concluded that was not the case.⁵²

Murphy I, 460 F.3d at 81. Murphy settled her claim against the New York Air National Guard in 1999. See *Leveille v. N.Y. Air Nat’l Guard*, No. 98-079, 1999 DOL Ad. Rev. Bd. LEXIS 105 (Dep’t of Labor Admin. Review Bd. Oct. 25, 1999). She included the \$70,000 as income in her income tax return in 2000. *Murphy II*, 493 F.3d at 171; *Murphy I*, 460 F.3d at 81.

⁴⁴ *Murphy I*, 460 F.3d at 80–81.

⁴⁵ See *Murphy v. Internal Revenue Service*, 362 F. Supp. 2d 206 (D.D.C. 2005), *rev’d*, 460 F.3d 79 (D.C. Cir. 2006), *aff’d on reh’g*, 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

⁴⁶ *Murphy I*, 460 F.3d at 83–84.

⁴⁷ The required connection between a physical injury and a recovery has yet to be fleshed out. The Service has provided limited guidance. See, e.g., I.R.S. Priv. Ltr. Rul. 2000-41-022 (Oct. 13, 2000) (concluding that recovery on a sexual harassment claim was governed by section 104(a)(2) when unwanted contact led to “observable bodily harms such as bruises, cuts, swelling, and bleeding”); I.R.S. Off. Mem. (CCA) 2008-09-001 (Nov. 27, 2007) (concluding that an adult’s recovery for sexual abuse suffered as child was excludable although physical effects were no longer apparent). The Tax Court’s guidance has been similarly limited. See, e.g., *Domeny v. Comm’r*, 99 T.C.M. (CCH) 1047, 1049 (2010) (holding that recovery for a hostile work environment that exacerbated symptoms of multiple sclerosis was “on account of” a personal sickness, but more was needed). Legal scholars have identified the need for guidance. See, e.g., William H. Volz & Vahe Tazian, *The Tax Treatment of Sexual Harassment Awards: Clarifying the Threshold for Exclusion*, 30 J. LEGIS. 275 (2004) (urging regulations). Robert Wood has pondered whether false imprisonment is a physical injury, see Robert W. Wood, *Are False Imprisonment Recoveries Taxable?*, 119 TAX NOTES 279 (2008) [hereinafter Wood, *False Imprisonment*], and has objected to the Tax Court’s negative conclusion on a related issue. See Robert W. Wood, *Why False Imprisonment Recoveries Should Not Be Taxable*, 123 TAX NOTES 1217 (2009) [hereinafter Wood, *False Imprisonment*] (discussing *Stadnyk v. Comm’r*, 96 T.C.M. (CCH) 475 (2008)).

⁴⁸ I shall also not discuss whether the Internal Revenue Service was an appropriate party.

⁴⁹ *Murphy I*, 460 F.3d at 88–92.

⁵⁰ *Id.*

⁵¹ See *id.* at 88 (citing *Raytheon Prod. Corp. v. Comm’r*, 144 F.2d 110, 113 (1st Cir.

As a result, if Congress intended to make such a recovery taxable when it limited the exclusion from gross income to recoveries for personal *physical* injuries or sickness, the panel determined it had acted unconstitutionally: “[W]e hold § 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.”⁵³ A recovery for emotional distress is not “incomes” within the meaning of the Sixteenth Amendment, and, if the tax was not on incomes, the rule requiring that direct taxes be apportioned should have applied. Because Congress had not apportioned the tax, it was invalid.⁵⁴

“Direct taxes”? “Apportionment”? Those constitutional terms require explication if the issues in *Murphy* are to be understood. I undertake that project in Part IV, after I first describe some of the howlers in *Murphy I*. The howlers are important; *Murphy I* was, in some respects, an embarrassment. But I shall go on to argue that the D.C. Circuit panel overreacted in *Murphy II* by jettisoning almost all that it had concluded the first time around.

III. THE HOWLERS IN *MURPHY I*

The *Murphy I* panel did a poor job, but the embarrassing aspects of Chief Judge Ginsburg’s opinion were not entirely the court’s fault. We cannot expect generalist judges to be experts on every statutory regime. They rely on lawyers to get the foundation right, and the government, presumably because it had no idea that a bombshell might come from an apparently routine case, did not help with the basics.

I here outline a few egregious mistakes Judge Ginsburg advanced on behalf of the panel. Some were trivial. A judge should not refer to *Eisner v. Macomber*⁵⁵ as *Eisner*,⁵⁶ but that sort of thing happens.⁵⁷ Referring to an “IRS” opinion from 1922 was equally harmless,⁵⁸ albeit historically challenged.⁵⁹ Other howlers, however, illustrated a

1944)).

⁵² See *id.* at 88–92.

⁵³ *Id.* at 92.

⁵⁴ *Id.*

⁵⁵ 252 U.S. 189 (1920).

⁵⁶ *Murphy I*, 460 F.3d at 85. *Eisner* was a Collector of Internal Revenue. Calling the case *Eisner* is like referring to *Commissioner v. Popeye* as *Commissioner*.

⁵⁷ See, e.g., *Comm’r v. Kowalski*, 434 U.S. 77, 94 (1977) (referring to “*Eisner*’s definition of income”). The government did not help. See Brief for the Appellees at 21, *Murphy I*, 460 F.3d 79 (No. 05-5139), 2005 WL 3598532 (referring to *Macomber* as “*Eisner*”).

⁵⁸ *Murphy I*, 460 F.3d at 91 (citing Sol. Op. 132, 1-1 C.B. 92, 93 (1922)).

⁵⁹ Originally the Bureau of Internal Revenue, the agency did not become the Internal Revenue Service until 1953, see T.D. 6038, 1953-2 C.B. 443, although the modern term was

striking unfamiliarity with basics of the federal tax system.

Misunderstanding constitutional authority to enact an income tax. Judge Ginsburg focused on the meaning of the term “income” because, in the panel’s view, “[t]he constitutional power of the Congress to tax income is provided in the Sixteenth Amendment, ratified in 1913.”⁶⁰ As I discuss in Part IV, that statement is as wrong as it can be. The power to tax income derives from the Taxing Clause in Article I, Section 8: “The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises”⁶¹ The Amendment simply provides that a “tax on incomes” is not subject to the apportionment rule for direct taxes.⁶² In that respect the Amendment made the modern income tax possible—an apportioned income tax would be a travesty—but authority to enact an income tax has been in the Constitution since its inception.

Failing to look for other constitutional authority for the tax. Focused as it was on the Sixteenth Amendment, the court did not consider whether the tax on the emotional-distress recovery might have been constitutional anyway, without regard to the Amendment. After all, most federal taxes are not “taxes on incomes,” but their constitutionality is taken for granted.⁶³

Jumping to constitutional analysis without looking at the statute first. The *Murphy I* panel violated a basic interpretive rule that applies whenever the constitutionality of a statute is at issue: see if the constitutional issue can be avoided. If the panel had looked to the meaning of “gross income” under section 61, and had understood how section 104(a)(2) affects that definition, it might not have had to reach constitutional issues. Indeed, since Judge Ginsburg had stated that “[t]he Supreme Court has held that the word ‘incomes’ in the Amendment and the phrase ‘gross income’ in § 61(a) of the IRC are coextensive,”⁶⁴ one might have expected the panel to wonder whether

used earlier on some tax forms. See, e.g., INTERNAL REVENUE SERVICE, FORM 1040: INDIVIDUAL INCOME TAX RETURN (1918), available at [http://www.taxhistory.org/thp/1040/forms.nsf/WebByYear/1918/\\$file/1040_1918.pdf](http://www.taxhistory.org/thp/1040/forms.nsf/WebByYear/1918/$file/1040_1918.pdf).

⁶⁰ *Murphy I*, 460 F.3d at 84.

⁶¹ U.S. CONST. art. I, § 8, cl. 1. But see Brief for the Appellees, *supra* note 57, at 28 (“Congress’s power to tax ‘income’ under the Sixteenth Amendment extends to the receipt of anything of value, measured in money (i.e., ‘accessions to wealth’), over which the taxpayer has dominion and control.” (emphasis omitted)).

⁶² See *infra* Part IV.

⁶³ In *Murphy II*, the panel wound up concluding that the tax on the emotional-distress recovery was properly characterized as an excise, making the Sixteenth Amendment irrelevant. See *Murphy II*, 493 F.3d 170, 186 (D.C. Cir. 2007), cert. denied, 553 U.S. 1004 (2008); see also *infra* Part VII.

⁶⁴ See *Murphy I*, 460 F.3d 79, 85 (D.C. Cir.), vacated, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

a recovery that was not income for constitutional purposes might also not have been gross income. Even if statutory interpretation was not decisive in *Murphy I*, the statute was the place to begin. It is always the place to begin.

Holding that section 104(a)(2) as applied to Murphy's facts was unconstitutional. The *Murphy I* court concluded that amended section 104(a)(2) is unconstitutional.⁶⁵ That conclusion reflects a misunderstanding of the statutory structure. As I discuss in Part V, section 104(a)(2) is an *exclusion* from gross income, the definition of which is found in section 61. When Congress amended section 104(a)(2) to limit its application to recoveries for personal *physical* injuries, it was narrowing an exclusion from gross income, not expanding the definition in section 61.⁶⁶ If Murphy's recovery fit within the terms of section 61, but the application of the tax to the recovery was impermissible, it was section 61 that must have been unconstitutional.

Misunderstanding returns of capital and returns of basis. Perhaps the greatest problem in *Murphy I* was the panel's botching of the analysis of basis.⁶⁷ The panel said it has long been recognized that mere restoration of capital is not income, either statutorily or constitutionally,⁶⁸ and Murphy characterized her award as a return of human capital. She argued she was merely made whole by the compensation—a \$70,000 loss was replaced by a \$70,000 recovery—and therefore had no income.⁶⁹

The government made the obvious response: recovery of *basis* is not taxable,⁷⁰ but individuals have no basis in human capital. Dispose

⁶⁵ *Id.* at 92.

⁶⁶ More is treated as income when an exclusion is narrowed, but section 61's boundaries were not expanded by amending section 104(a)(2). See *Suder v. Comm'r*, No. 3245-06S, T.C. Summ. Op. 2008-97, at 4 (Aug. 7, 2008) (admonishing a couple who, relying on *Murphy I*, had argued that a settlement payment was not income and that, if section 104(a)(2) made it income, that section was invalid: "If the settlement proceeds were not includable in gross income under section 61, then the constitutionality of section 104(a)(2) would be irrelevant.").

⁶⁷ I am not certain the panel misunderstood as much as many have suggested, but, at best, the panel did a poor job of explanation.

⁶⁸ *Murphy I*, 460 F.3d at 85.

⁶⁹ *Id.*

⁷⁰ In fact, the government conceded that basis recovery may not be taxed as a matter of constitutional law. See *id.* at 87. I agree with the concession, but not everyone does. See, e.g., Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 6, at 394-97. Rejecting the idea that a "netting principle" is constitutionally required, Professor Dodge sees no difference between Congress's limiting deductions—no one believes it must permit every conceivable deduction—and its power to "disallow basis or basis recovery." Joseph M. Dodge, *The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress from Disallowing Such Costs*, 27 VA. TAX REV. 297, 370 (2007) [hereinafter Dodge, *Netting of Costs*]. Congress needs leeway, but disallowing all deductions (or basis recovery) is inconsistent with a "tax on incomes."

of an item of capital with a zero basis, and all proceeds will be gain.⁷¹

I will return to the consideration of human capital later.⁷² Suffice it to say for present purposes that the panel in *Murphy I* did not meet the government's argument head-on,⁷³ a failure that caused scholarly dismay. Moreover, passages in the opinion could be interpreted to suggest the judges did not understand *basis* and *gain*. The court said a recovery that merely makes a taxpayer whole—for example, \$70,000 to replace a \$70,000 item of converted property—cannot be income.⁷⁴ Wrong.⁷⁵ The appropriate comparison is not between value received and value given up, which should be equal in an arm's-length transaction, but between value received and basis of property surrendered.⁷⁶

On the misunderstanding that gave rise to this howler, the government had not been helpful. In its brief, the government advanced an argument indicating that it too misunderstood the concept of "gain."⁷⁷ It said compensatory damages like those in *Murphy* "plainly constitute economic gain, for the taxpayer unquestionably has more money after receiving the damages than she had prior to receipt of the award."⁷⁸ The idea that more money

⁷¹ Gain is the difference between amount realized and basis. See I.R.C. § 1001(a) (2006). If no basis exists, gain will equal amount realized—what the government said the *Murphy* result should have been.

⁷² I am unconvinced that what might be called human capital necessarily has no basis or that it is necessarily true that compensation for involuntary losses of human capital were intended to be reached by the income tax. See *infra* Part V.B.3.

⁷³ See *Murphy I*, 460 F.3d at 88 ("The question in this case is not . . . about a return of capital . . . ; the question is whether the compensation she received for her injuries is income.").

⁷⁴ See *id.*

⁷⁵ Authority on which critics of *Murphy I* rely did no better, which is why *Murphy*'s lawyers thought she had a shot. The *Glenshaw Glass* Court distinguished the "long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital" from the situation with punitive damages, which "cannot be considered a restoration of capital." *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955). That distinction was repeated in *O'Gilvie v. United States*, 519 U.S. 79, 84 (1996) (citing cases holding "restoration of capital was not income"); see also *id.* at 86 (suggesting damages "that aim to substitute for a victim's physical or personal well-being" are not taxable).

⁷⁶ The definitive article is Deborah A. Geier, *Murphy and the Evolution of 'Basis'*, 113 TAX NOTES 576 (2006). Professor Geier argues that the *Murphy I* panel got hung up on rulings from the early years of the income tax, before the modern concept of basis had been developed. See *id.* at 576–77 ("[T]he panel opinion appears to hold that our understanding of the core concept of tax basis (or capital) must be frozen as of 1913 . . ."). What we would call basis was often considered to be fair market value at acquisition. *Id.* at 580–81. *Taft v. Bowers*, 278 U.S. 470 (1929), which upheld an argument under the Revenue Act of 1921 that a donee's basis in appreciated property should be the donor's, moved the system away from 1913 concepts. Geier, *supra*, at 581; see also *Taft*, 278 U.S. at 484 ("[N]othing in the Constitution . . . lends support to the theory that gain . . . can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property.").

⁷⁷ See Brief for the Appellees, *supra* note 57, at 28.

⁷⁸ *Murphy I*, 460 F.3d at 86 (quoting Brief for the Appellees, *supra* note 57, at 28).

necessarily means economic gain is absurd—and demonstrates why the *Murphy I* panel was able to characterize the government's position as "breathhtakingly expansive."⁷⁹ The sale of a widget with basis of \$70,000 for \$70,000 in cash gives rise to no income. The nature of the assets has changed, but there has been no accession to wealth.⁸⁰ The fact that you have new cash in your hand does not mean the transaction is taxable.

The two sets of lawyers took diametric positions, but both seemed to misunderstand basis. The position of Murphy's advisors, largely accepted by the panel in *Murphy I*, was this: Pay no attention to basis. Compensation for conversion of capital is tax-free in its entirety regardless of basis. The government's position was also unfounded: Pay no attention to basis. If cash is received, the amount of the cash is income. We all ought to be able to do better than this.

IV. DIRECT TAXES AND THE SIXTEENTH AMENDMENT

It is finally time to get into the merits of the dispute in *Murphy*. I look first, in this part of the Article, at the constitutional structure that was involved in the *Murphy* litigation. In Part V, I then turn to the relevant statutory structure. The panel in *Murphy I* thought the Sixteenth Amendment was decisive: Murphy's recovery for emotional distress was not "incomes" and therefore could not be reached by the income tax. What does the Amendment do, and when is it relevant?

A. The Constitutional Structure

The Sixteenth Amendment, ratified in 1913, provides that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."⁸¹ People often say the Amendment authorized an income tax—Judge Ginsburg stated this in *Murphy I*⁸²—but that assumption is wrong. The Taxing Clause, granting Congress the "Power To lay and collect Taxes,

⁷⁹ See *id.* at 87; see also *supra* note 5 and accompanying text (discussing the court's reaction to the government's position). The IRS brief said things like "Congress's power to tax 'income' is broad-sweeping and extends to the receipt of anything of value, measurable in money (i.e., 'accessions to wealth'), over which the taxpayer has dominion and control." Brief for the Appellees, *supra* note 57, at 15.

⁸⁰ Even those who take an expansive view of amended section 104(a)(2) concede that a recovery of cash is not taxable if it reflects recovery of basis. See *infra* Part V.B.1.

⁸¹ U.S. CONST. amend. XVI.

⁸² See *supra* text accompanying note 60.

Duties, Imposts and Excises,” did that on its own.⁸³ The Amendment made possible an *unapportioned* income tax like we have today.

An income tax was a problem before the Amendment because of the requirement (noted twice in the direct-tax clauses of Article I) that a direct tax must be apportioned among the states on the basis of population.⁸⁴ In 1895, in *Pollock v. Farmers' Loan & Trust Co.*,⁸⁵ the Supreme Court had held that the 1894 income tax was invalid because it was direct and Congress had not satisfied the apportionment requirement.⁸⁶

A response to *Pollock*, the Sixteenth Amendment exempted “taxes on incomes” from apportionment.⁸⁷ That was critical because the apportionment requirement, when it does apply, is a real pain. Residents of a state with one-twentieth of the national population, for example, must in the aggregate pay one-twentieth of the total liability for any direct tax, regardless of how the tax base (real-estate value, say) is distributed across the country.

Because incomes vary from state to state, an apportioned income tax could not be based on ability to pay. If an income tax had to be apportioned, the numbers could be made to work, but doing so would not be easy.⁸⁸ Some mechanism would have to ensure that each state pays the requisite percentage of the national tax liability—probably meaning that tax rates would be *higher* in a poor state than in a rich one.⁸⁹ Even if some other method were used, the bottom line is that a higher percentage of a poor state's income would be taken in federal income taxes—a counterintuitive system, to put it mildly. Indeed, as the Supreme Court said in *Springer v. United States*,⁹⁰ the 1881

⁸³ U.S. CONST. art. I, § 8, cl. 1.

⁸⁴ See U.S. CONST. art. I, § 2 (“Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers . . .”); U.S. CONST. art. I, § 9, cl. 4 (“No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.”).

⁸⁵ 157 U.S. 429, *modified on reh'g*, 158 U.S. 601 (1895).

⁸⁶ 158 U.S. at 637.

⁸⁷ See Jensen, *Meaning of Incomes*, *supra* note 19, at 1114–23.

⁸⁸ Congress did apportion a number of antebellum taxes on real estate. Apportionment can be done, clunky though it is. See Act of Aug. 5, 1861, ch. 45, § 13, 12 Stat. 292, 297; Act of Mar. 5, 1816, ch. 24, § 6, 3 Stat. 255, 256; Act of Feb. 27, 1815, ch. 60, § 1, 3 Stat. 216, 216; Act of Jan. 9, 1815, ch. 21, § 5, 3 Stat. 164, 166; Act of Aug. 2, 1813, ch. 37, § 3, 3 Stat. 53, 71; Act of July 14, 1798, ch. 75, § 2, 1 Stat. 597, 598.

⁸⁹ Suppose state A has two citizens, each of whom earns \$100,000 per year. State B also has two citizens, each of whom earns \$10,000 per year. An apportioned income tax would have to collect the same amount of revenue from each state. If the figure is \$2,000 per state, the income of each state A citizen would have to be taxed at a one percent rate, while the rate in state B would have to be *ten* percent. And the targets would be moving. As national income and population shift geographically, the rate structures would have to be adjusted, after each census, to satisfy the apportionment requirement.

⁹⁰ 102 U.S. 586 (1881).

decision upholding an unapportioned Civil War income tax, “Where the population is large and the incomes are few and small, [apportionment] would be intolerably oppressive.”⁹¹

Counterintuitive, oppressive, and even stupid? Well, apportionment would seem stupid if Congress were actually to try to apportion an income tax or any other tax, the base of which is not distributed proportionately to population. If income and population were distributed in a more or less proportionate way—if each state had about the same percentage of national population *and* income—apportioning an income tax would be easy (and pointless⁹²). But proportionality of that sort did not exist in 1789, it does not exist today, and it is hard to imagine it ever would exist. In the real world, an apportioned income tax would be crazy, an object of ridicule.⁹³

Apportionment is not so bizarre, however, if understood as a limitation on congressional power. One hopes that Congress would ordinarily not want to appear ridiculous,⁹⁴ and apportionment provides a disincentive to enact a tax with decidedly sectional effects.⁹⁵ Requiring apportionment when the tax base and population are not distributed proportionately—when, if there were no apportionment rule, representatives of poorer states might try to gang up on those from richer ones⁹⁶—would mean, as a practical matter, that Congress would be unlikely to enact the direct tax.⁹⁷ That is the point.

⁹¹ *Id.* at 600.

⁹² Professor Johnson has argued that apportionment should apply only to taxes the bases of which are distributed proportionately to population. See Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 CONST. COMMENT. 295, 297–98, 314–18 (2004) [hereinafter Johnson, *Constitutional Absurdity*]. That would make the direct-tax clauses superfluous.

⁹³ See *id.* at 296.

⁹⁴ One would expect an apportioned tax to be used only when revenue needs trump everything else. See Erik M. Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2382–83 (1997) [hereinafter Jensen, *Consumption Taxes*]. When Congress enacted apportioned property taxes between 1798 and 1861, it did so because of war or anticipation of war. See *supra* note 88 (listing specific acts of Congress creating apportioned property taxes).

⁹⁵ Although apportionment has far broader application, southern proponents clearly had slavery in mind. If northerners had sought to tax slaves, their own states would have borne a share of the national tax liability. Who would have voted for such a tax? (Slaves were in fact reached by early taxes on real estate but the theory was that slaves were inextricably linked to real property.)

⁹⁶ The uniformity rule has been interpreted to require only that a duty, impost, or excise apply in the same way across the country, regardless of whether the tax base is distributed uniformly. A tariff is geographically uniform if it applies similarly in all ports even though many states have no ports. See Erik M. Jensen, *THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION 77–88* (Jack Stark ed., 2005) [hereinafter JENSEN, *THE TAXING POWER*]. The uniformity rule thus provides no protection against a tax that is uniform in this respect but that has geographically discriminatory effects.

⁹⁷ I have made this argument several times. See, e.g., Erik M. Jensen, *Interpreting the*

With the Sixteenth Amendment on the books, we are so used to an unapportioned income tax that thinking in these terms seems peculiar. Concerns about sectional taxes, however, were not remote when the Constitution was ratified in 1789, or in the late nineteenth and early twentieth centuries, when debates about an income tax were vitriolic.⁹⁸ The 1894 income tax was a reaction to consumption taxes, particularly tariffs, which had become the primary revenue source for the national government, but were thought to hit low-income persons unfairly.⁹⁹ The income tax was structured to reach only the wealthy, and the wealthy were concentrated in the industrial Northeast. There was a decidedly sectional aspect to the tax.¹⁰⁰

Because of the 1796 Supreme Court decision in *Hylton v. United States*,¹⁰¹ which had concluded that the direct-tax clauses apply to very little,¹⁰² and the 1881 decision in *Springer*, which upheld the unapportioned Civil War income tax,¹⁰³ most commentators at the time thought the 1894 tax would easily pass constitutional muster. But in *Pollock*, decided only fourteen years after *Springer*, a divided Court (5–4) held that the 1894 income tax was direct and, because not apportioned, constitutionally invalid.¹⁰⁴ In some respects, *Pollock* turned the world upside-down, but the majority actually did a nice job of connecting with *Hylton*.

The Founders said nothing about an income tax, a concept that was at best rudimentarily understood in the late eighteenth century. In debates, they provided only two examples of direct taxes that had to be apportioned—capitation taxes (specifically mentioned in the Constitution)¹⁰⁵ and real-estate taxes. In dicta in *Hylton*, which upheld an unapportioned federal tax on carriages, three of the four Justices intimated that no other tax could be direct,¹⁰⁶ and two said also that

Sixteenth Amendment (By Way of the Direct-Tax Clauses), 21 CONST. COMMENT. 355 (2004) [hereinafter Jensen, *Interpreting the Sixteenth Amendment*].

⁹⁸ See Jensen, *Meaning of Incomes*, *supra* note 19, at 1100–07.

⁹⁹ The income tax had populist support, but its appeal was much broader. There was a widespread feeling that tariffs were unfair in their application. See *id.* at 1095–96.

¹⁰⁰ See *id.* at 1096–97. An apportioned income tax could not be based on ability to pay: rates would have to be higher in poor states than in rich ones. See *supra* notes 87–90 and accompanying text.

¹⁰¹ 3 U.S. (3 Dall.) 171 (1796).

¹⁰² See *id.* (Chase, Iredell & Paterson, JJ., seriatim).

¹⁰³ *Springer v. United States*, 102 U.S. 586, 602 (1881).

¹⁰⁴ See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *modified on reh'g*, 158 U.S. 601 (1895).

¹⁰⁵ See U.S. CONST. art. I, § 9, cl. 4.

¹⁰⁶ See *Hylton*, 3 U.S. (3 Dall.) at 183 (opinion of Iredell, J.) (“In regard to other articles, there may possibly be considerable doubt.”); *id.* at 177 (opinion of Paterson, J.) (“I never entertained a doubt, that the principal, I will not say, the only, objects, that the framers of the

apportionment should be required only when it is easy to do—when, that is, population and the tax base are distributed proportionately.¹⁰⁷

The *Hylton* dicta were repeated in many nineteenth-century cases, including *Springer*,¹⁰⁸ as if they were unquestionably correct and as if an income tax could not possibly be a problem as long as it satisfied the Uniformity Clause. The Supreme Court in 1796 was made up of Founders, and who better, it was argued, to understand the original meaning of the Constitution?

But the dicta should always have been viewed skeptically. For one thing, although the *Hylton* Justices were Founders, they were also Federalists, with every incentive to support the Federalist government.¹⁰⁹ If apportionment were to be required only when it is easy, the direct-tax clauses would be meaningless. Furthermore, the dicta were inconsistent with each other¹¹⁰ and with constitutional language. If the Founders intended apportionment for only capitation taxes and real-estate taxes, it would have been easy to draft the rule accordingly. Instead, they used the phrase “Capitation, or other direct, Tax,”¹¹¹ suggesting a broader application for the clauses.

Even more important, the implicit assumption in *Hylton* was that the Founders intended to constrain only those taxes with which they were familiar. Those today who treat *Hylton* as gospel make the same assumption: any levy not envisioned by tax theoreticians in 1789 must be exempt from apportionment. That is a strange way to

Constitution contemplated as falling within the rule of apportionment, were a capitation tax and a tax on land.”); *id.* at 175 (opinion of Chase, J.) (stating that direct taxes “contemplated by the Constitution, are only two, to wit, a capitation, or poll tax, [s]imply, without regard to property, profession, or any other circumstance; and a tax on LAND.”).

¹⁰⁷ See *id.* at 181 (opinion of Iredell, J.) (“As all direct taxes must be apportioned, it is evident that the Constitution contemplated none as direct, but such as could be apportioned. If this cannot be apportioned, it is, therefore, not a direct tax in the sense of the Constitution.”); *id.* at 174 (opinion of Chase, J.) (“The Constitution evidently contemplated no taxes as direct taxes, but only such as Congress could lay in proportion to the census. The rule of apportionment is only to be adopted in such cases, where it can reasonably apply; and the subject taxed, must ever determine the application of the rule.”).

¹⁰⁸ See, e.g., *Springer*, 102 U.S. at 602 (“[D]irect taxes, within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate . . .”); *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533, 543 (1869) (“[P]ersonal property, contracts, occupations, and the like, have never been regarded by Congress as proper subjects of direct tax.”).

¹⁰⁹ The Court did not see itself as a check on other branches. See Jensen, *Consumption Taxes*, *supra* note 94, at 2361.

¹¹⁰ Although a tax on real estate could be apportioned—Congress did that several times between 1798 and 1861, see *supra* note 88—it was not easy. There was no reason to think population and real-estate value (or any other measure that might be used to tax real estate) were distributed proportionately.

¹¹¹ U.S. CONST. art. I, § 9, cl. 4.

interpret a constitutional limitation;¹¹² indeed, it is a dumb way.¹¹³ It is as if we should interpret the Fourth Amendment as having no effect on electronic surveillance because even Benjamin Franklin could not have imagined twenty-first century electronics.¹¹⁴

The result in *Pollock* was unpopular; a tax structured to reach the wealthy was favored by the vast majority not subject to the tax. And, it was said with reason, *Pollock* was contrary to Supreme Court authority going back to *Hylton*. (Although the *Hylton* statements were technically dicta, they had metamorphosed in the minds of many into “authority.”) But the *Pollock* majority made an effort to tie its conclusion to *Hylton*, using the following syllogism: (1) The *Hylton* Court had said a tax on real property is direct. (2) Taxing income from real property is constitutionally indistinguishable from taxing the property itself, since either tax diminishes the value of the property. (3) Because no distinction of constitutional dimension would justify treating income from *personal* property differently from income from *real* property, a tax on any income from property is direct. (4) Finally, because the unapportioned income tax was overwhelmingly directed at income from property (the income of the wealthy), the entire statute had to fall.¹¹⁵

Whatever *Pollock*’s merits—even if it was so clearly wrong that it should have had no legal weight, as many thought—it was on the books,¹¹⁶ and it became apparent there would be no income tax without a constitutional amendment.¹¹⁷ It is in that respect that the

¹¹² I cannot prove what a Founder would have thought about a new tax. But I am sure that, if he had been asked if such a tax would automatically be exempt from apportionment, the answer would have been no. Otherwise, the Constitution would not have been ratified. See Erik M. Jensen, *Taxation and the Constitution: How to Read the Direct-Tax Clauses*, 15 J.L. & POL. 687, 689 (1999) [hereinafter Jensen, *How to Read*]; see also Erik M. Jensen, *The Constitution Matters in Taxation*, 100 TAX NOTES 821, 826–27 (2003).

¹¹³ Many who see a limited role for the direct-tax apportionment rule show disdain for the effort to understand original meaning—*except* when something, like the *Hylton* dicta, supports their predilections.

¹¹⁴ Cf. *Kyllo v. United States*, 533 U.S. 27, 33–34 (2001) (“It would be foolish to contend that the degree of privacy secured to citizens by the Fourth Amendment has been entirely unaffected by the advance of technology.”); Brian C. Andersorf & Adam D. Thierer, *Killing Talk Radio*, NEW CRITERION, Sept. 2008, at 18, 20 (quoting former FCC Commissioner Dennis Patrick that the Fairness Doctrine is “unconstitutional on its face”: “[t]o suggest otherwise is to suggest the framers of our constitution intended to protect from federal coercion only those who used the technology of the day—a proposition absurd on its face” (internal quotation marks omitted)).

¹¹⁵ See Jensen, *Consumption Taxes*, *supra* note 94, at 2369–70. A further benefit of this analysis was that, by focusing on income from property, the *Pollock* Court did not have to overrule *Springer*. See *infra* Part IV.C.2.

¹¹⁶ I do not defend all of *Pollock*’s anti-revolutionary bombast, but I defend the result: an income tax is direct. See *infra* Part IV.C.1; see also Jensen, *Consumption Taxes*, *supra* note 94, at 2372–85; Jensen, *Meaning of Incomes*, *supra* note 19, at 1071–73.

¹¹⁷ Some income-tax proponents argued that Congress should simply enact a new income

Sixteenth Amendment, by providing that the apportionment rule would not apply to “taxes on incomes,” made possible the modern income tax—an *unapportioned* income tax.¹¹⁸

Some congressmen wanted to go further and repeal the direct-tax clauses, so that apportionment would never again be an issue for any tax, but the Amendment’s sponsor, Senator Norris Brown of Nebraska, rejected language that would have done that.¹¹⁹ (Perhaps Brown thought a narrow provision—exempting only *taxes on incomes*—made ratification easier.) Although the Amendment limited the direct-tax clauses, they remain in the Constitution.¹²⁰

B. Does Any of This Matter Anymore?

The Sixteenth Amendment did not do away with the direct-tax clauses, suggesting that some forms of taxation might still be subject to apportionment.¹²¹ But maybe I have devoted too much effort to parsing constitutional text and not enough to understanding reality. Perhaps none of this matters anymore—Professor Caron thinks we should not have to examine “entrails” of Founding-era debates to understand the taxing power¹²²—and maybe constitutional issues were not worth discussing in *Murphy I*.

The Supreme Court has had no recent occasion to consider the meaning of the direct-tax clauses and the Sixteenth Amendment, but the general scholarly understanding points toward their irrelevance. The conventional wisdom is that the Taxing Clause gives Congress

tax and give the Court the opportunity to ditch *Pollock*. But this strategy was resisted: doing that could offend the Court, and there was no guarantee it would overrule *Pollock*. Furthermore, a reaffirmation of *Pollock* might have delayed enactment of an income tax indefinitely. See Jensen, *Meaning of Incomes*, *supra* note 19, at 1109–14.

¹¹⁸ An unapportioned income tax would have none of the stupid effects that would come from an apportioned income tax (if such a tax could ever have been enacted). But doing away with apportionment also meant that Congress could impose a tax with sectional effects: the burdens of an unapportioned income tax are disproportionately borne by the wealthier parts of the country.

¹¹⁹ See Jensen, *Meaning of Incomes*, *supra* note 19, at 1116.

¹²⁰ See *id.* at 1114–23. Although aimed at *Pollock*, the Amendment was in form agnostic about the case’s merits. If *Pollock* was wrong, the Amendment was legal surplusage. If *Pollock* was right, the Amendment changed the law. Either way, an income tax need not be apportioned.

¹²¹ What that should mean, as a practical matter, is that, if Congress were aware of the problem, it would not enact a direct tax.

¹²² Caron, *supra* note 8, at 87 (“Examining the entrails of the constitutional compromise between Northern and Southern states over slavery sheds little light on modern day disputes over the Government’s power to tax its citizens.”). The form of the apportionment rule might have been due to slavery, see *supra* note 95, but the Constitution would not have been ratified without limitations on the taxing power. If apportionment had not been used, something else would have been. Should we be able to say, “We do not like this particular mechanism, so we will enforce no limits”?

nearly unlimited power in taxation; that *Pollock* was so clearly wrong that it can be ignored; and that, if *Pollock* was wrong, the Amendment was unnecessary and, in any event, should not constrain taxation. As Professor Caron has put it, "[T]he constitutional limitations on the taxing power do not serve the needs of the twenty-first century American economy and society."¹²³

But *Pollock* is still on the books and is unlikely to be overturned in its entirety.¹²⁴ And the Sixteenth Amendment did not repeal the direct-tax clauses; it merely exempted "taxes on incomes" from apportionment. To deal with these inconvenient propositions, which suggest that a direct tax that is not on incomes must still be apportioned (if enacted at all), proponents of a strong taxing power often take another tack to conclude that Congress can do what it wants: If Congress says a tax is on *income*, the Amendment controls, and apportionment is not required.¹²⁵

The argument effectively is that Congress has the power to avoid constitutional restrictions by labeling an enactment in the right way.¹²⁶ If Congress hides an unapportioned direct tax in the income-tax provisions of the Code, but characterizes the tax as one on income, that characterization generally should end the discussion.¹²⁷

¹²³ Caron, *supra* note 8, at 87.

¹²⁴ Part of *Pollock* was overturned in *South Carolina v. Baker*, 485 U.S. 505 (1988) (holding that the Constitution does not forbid taxing interest on bonds issued by states), and other parts have been chipped away. See Jensen, *Consumption Taxes*, *supra* note 94, at 2375-77. But the core of *Pollock* is unlikely to disappear. It is hard to imagine a dispute that would present the question cleanly; apportionment is not required for a "tax on incomes" whether or not *Pollock* was correct. Had the panel not reversed direction, *Murphy I* would have given the Court an opportunity to reconsider *Pollock*, but *Murphy II* effectively mooted the issue.

¹²⁵ As one commentator argues:

[T]he Sixteenth Amendment must give Congress a fully vested power to tax *all* income, however Congress defines it, without worrying about fine distinctions. Such an interpretation yields a meaning of income that is broad and evolutionary. Income's meaning is to be determined by Congress, not the Court, and that meaning changes over time as congressional conceptions of income change and become more sophisticated.

Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 24 (1992); see also Jensen, *Meaning of Incomes*, *supra* note 19, at 1087-91, 1133-47.

¹²⁶ In *Murphy II*, the panel took a slightly different tack: mislabeling does not matter if the levy would not be subject to the apportionment rule anyway. See *infra* text accompanying note 510.

¹²⁷ Could Congress say an ad valorem property tax is on income and avoid apportionment? I think not. The *Hylton* Court thought a real-estate tax was direct, see *supra* note 106, and early Congresses apportioned such taxes. See *supra* note 88 (citing congressional enactments of apportioned real-estate taxes). Nothing in the Sixteenth Amendment's history suggests its drafters intended to affect real-estate taxes. See Germain, *supra* note 29, at 240 ("[U]nder the consistent rulings of the Supreme Court, Congress would still not be able to impose a traditional

Professor F. Patrick Hubbard has rightly criticized this “constitutional desuetude”—the idea that “taxation is so important and complex that the Supreme Court should simply allow Congress to make policy choices without interference because, in the modern context, constitutional limits on Congress’s power to tax are so outmoded, arbitrary, and inapplicable that the proper approach is simply to ignore or reject them.”¹²⁸ Maybe “constitutional desuetude” describes what goes on in the real world, and, yes, apportionment is cumbersome. But Congress should not have the power, by an artful choice of labels, to sidestep constitutional requirements.

Constitutional desuetude was not the prevailing view after ratification of the Sixteenth Amendment. Several Supreme Court decisions from that era held that, for an unapportioned direct tax to be protected by the Amendment, it really must be on *income*. The best known example is *Eisner v. Macomber*,¹²⁹ where the Court in 1920 struck down an unapportioned income tax as it applied to stock dividends that did not change recipients’ percentage interests in the distributing corporation.¹³⁰ In effect, the Court concluded, the Amendment presupposes a realization principle: accessions to wealth must be “realized” before they may be reached by an unapportioned “tax on incomes.” And what had happened in *Macomber*—slicing the corporate pie into more pieces, but with each person’s share unchanged—was not a realization event. Although the unapportioned income tax as a whole was valid, the stock dividends were not income to *Macomber*.¹³¹ The tax as it applied to those dividends thus remained direct—*Pollock* survived to that extent—but it was not protected by the Amendment.¹³²

Through the 1920s, the Court stressed that Congress could not circumvent apportionment simply by labeling a levy an *income* tax, or hiding a non-income tax within the income-tax statute. Although most commentators think those cases are no longer good law, they have not been overruled. In two cases decided shortly after *Macomber*, the Court held the Sixteenth Amendment had controlling effect.¹³³

ad valorem real property tax without apportionment.”).

¹²⁸ Hubbard, *supra* note 20, at 755.

¹²⁹ 252 U.S. 189 (1920).

¹³⁰ *Id.* at 219.

¹³¹ *See id.*

¹³² *Id.*

¹³³ *See* *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, 633 (1925) (concluding that cash subsidy payments made by the Cuban government to facilitate railroad construction “were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment.”);

In many other cases, it was taken for granted that "taxes on incomes" means something. The Court usually made that point when a statute was deemed to meet constitutional standards anyway, and the point was therefore dictum in those cases. But the Court nevertheless felt it necessary to emphasize that constitutional language was being taken seriously. For example, in *Burk-Waggoner Oil Association v. Hopkins*,¹³⁴ Justice Brandeis, who had dissented in *Macomber*,¹³⁵ conceded that "Congress cannot make a thing income which is not so in fact."¹³⁶

To be sure, the meaning of "incomes" matters, as the panel in *Murphy I* thought it does, only if the term "direct tax" has content. We need not care about carving "taxes on incomes" out of the apportionment rule if the rule applies to little or nothing anyway. Professor Calvin Johnson has argued that the Supreme Court got it right in *Hylton*, recognizing that apportionment was absurd and effectively limiting the rule only to taxes that can be easily apportioned.¹³⁷ And Johnson applauds the other *Hylton* dictum that "direct taxes" includes at most capitation and real-estate taxes.¹³⁸

Weiss v. Stearn, 265 U.S. 242 (1924) (extending *Macomber's* principles to corporate reorganizations in which a shareholder maintained a stock interest in a new corporation formed under the laws of the same state). The *Cuba Railroad* Court stressed that "[t]he Sixteenth Amendment, like other laws authorizing or imposing taxes, is to be taken as written and is not to be extended beyond the meaning clearly indicated by the language used." *Cuba R.R.*, 268 U.S. at 631.

¹³⁴ 269 U.S. 110 (1925) (holding Congress may impose a corporate income tax on earnings of an unincorporated joint stock company denominated a partnership under state law).

¹³⁵ See *Macomber*, 252 U.S. at 220–38 (Brandeis & Clarke, JJ., dissenting).

¹³⁶ *Burk-Waggoner*, 269 U.S. at 114; see also *Helvering v. Indep. Life Ins. Co.*, 292 U.S. 371, 379 (1934) ("The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment."); *Taft v. Bowers*, 278 U.S. 470, 481 (1929) ("[T]he settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income."); *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 174 (1926) ("It was not the purpose or effect of [the Sixteenth] Amendment to bring any new subject within the taxing power."); *Merchs.' Loan & Trust Co. v. Smietanka*, 255 U.S. 509, 519 (1921) ("In determining the definition of . . . 'income' . . . this court has . . . approved . . . what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment . . ."). In *James v. United States*, 366 U.S. 213 (1961), Justice Whittaker (joined by Justices Black and Douglas) concluded in dissent that embezzled funds were not income. *Id.* at 249 (Whittaker, Black & Douglas, JJ., concurring in part and dissenting in part). The majority relied on the broad taxing power, *id.* at 218 (majority opinion), but Justice Whittaker disagreed: "Equally well settled is the principle that the Sixteenth Amendment 'is to be taken as written and is not to be extended beyond the meaning clearly indicated by the language used.'" *Id.* at 249 (Whittaker, Black & Douglas, JJ., concurring in part and dissenting in part) (quoting *Cuba R.R.*, 268 U.S. at 631). But see *Rutkin v. United States*, 343 U.S. 130, 138–39 (1952) ("We think the power of Congress to tax these [illegal] receipts as income under the Sixteenth Amendment is unquestionable.").

¹³⁷ See Johnson, *Constitutional Absurdity*, *supra* note 92, at 324–27, 333–36.

¹³⁸ Johnson goes further, arguing that the logic of the Founders' position should also

Advocating a tax on wealth, Professor Bruce Ackerman has argued that, because the direct-tax clauses were part of a reprehensible compromise with slavery, the apportionment rule should apply, at most, to capitation taxes.¹³⁹ If so, the rule is not even a potential constraint on the taxing power.¹⁴⁰

Johnson and Ackerman are influential people, but their pronouncements are not the law. Their articulation of the term “direct tax” is inconsistent with the original understanding of the direct-tax clauses and the Sixteenth Amendment.¹⁴¹ The Amendment accepted the existence of a body of taxes subject to the clauses—at a minimum including a tax on real estate—and excepted only “taxes on incomes” from apportionment.¹⁴² And the idea that apportionment should be required only when easy would gut the clauses.¹⁴³

So how should one evaluate the constitutional validity of an unapportioned tax? Determine first whether the tax is direct. If the answer is yes, the unapportioned tax is invalid, unless it is a tax on incomes protected by the Sixteenth Amendment. If, however, the answer is no—if, that is, the tax is “indirect” (a duty, excise, or impost)—then apportionment is not required. For an indirect tax, the only constitutional question is whether the uniformity requirement has been satisfied.¹⁴⁴ Uniformity is not a problem if a particular item

exempt real-estate taxes, which were understood to be direct but which require dexterity to apportion, from the rule. See Calvin H. Johnson, *Purging Out Pollock: The Constitutionality of Federal Wealth or Sales Taxes*, 97 TAX NOTES 1723 (2002). The Founders’ understanding that a real-estate tax is direct is clear from Founding debates and *Hylton*. If the *Hylton* Justices, disinclined to see limitations on the taxing power, saw real-estate taxes as direct, we should pay attention. Moreover, beginning in 1798, Congress enacted several such taxes that were apportioned. See *supra* note 88 (citing congressional enactments of apportioned real estate taxes).

¹³⁹ See Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 58 (1999).

¹⁴⁰ It is not a constraint if “capitation tax” means a lump-sum head tax. Putting aside questions about who gets counted and how—a slave counted as three-fifths of a person for this purpose and for representation—a lump-sum tax is by its very nature apportioned. See Jensen, *Consumption Taxes*, *supra* note 94, at 2390–93.

¹⁴¹ Although Professor Ackerman calls what happened a compromise with slavery, counting slaves at all in the direct-tax apportionment process was *detrimental* to slave states. The larger the population count, the greater the state’s tax liability. Southern states wanted slaves to be counted as full persons for purposes of representation, but not at all for tax purposes.

¹⁴² Many thought *Pollock* was wrong and, as a legal matter, the Amendment was unnecessary. But that is not to say the concept of “direct tax” was without content. At a minimum, taxes considered direct historically—real-estate and capitation taxes—should have been unaffected by the Amendment.

¹⁴³ The government in *Murphy II* nevertheless argued (unsuccessfully) that the clauses should be interpreted in this way. See *Murphy II*, 493 F.3d 170, 182 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

¹⁴⁴ See U.S. CONST. art. I, § 8, cl. 1. The apportionment and uniformity rules are mutually exclusive. Except in unusual circumstances, a tax that is apportioned will not be uniform, and, if

is taxed consistently across the country.¹⁴⁵

That sets the stage for the constitutional analysis in *Murphy*—why the definition of “incomes” in the Sixteenth Amendment might matter. If an unapportioned tax levied on an emotional-distress recovery is direct, it is valid only if it is a tax on incomes.¹⁴⁶

C. What Is a Direct Tax?

What other than a capitation tax and a tax on property might be a direct tax? Might that category include a levy on an emotional-distress recovery? Those questions obviously have no clear answers, but the uncertainty is not as great as many think. I shall argue that, under the constitutional structure, an income tax is direct (as the Court concluded in *Pollock*), and a subset of that tax—a levy on an emotional-distress recovery—is direct as well. The *Murphy I* panel was correct that, if the constitutional issues had to be reached—if the Internal Revenue Code reached the recovery¹⁴⁷—the unapportioned tax on Ms. Murphy was valid only if it was “on incomes.”

1. Direct Taxes Are (Would You Believe It?) Not Indirect Taxes

In several articles, I have argued that the universe of direct taxes is far broader than suggested in *Hylton v. United States*.¹⁴⁸ It cannot be that the only taxes subject to a limitation are those known in 1789 and for which apportionment provides no constraint. Certain principles were understood to distinguish direct taxes, subject to the apportionment rule, from other levies, the so-called indirect taxes (“Duties, Imposts and Excises”¹⁴⁹), which need to satisfy only the uniformity requirement. Those principles should be applied to determine whether a modern tax of a sort unknown to the Founders is direct or not.

In introducing what became the direct-tax clauses, Gouverneur Morris distinguished between direct and indirect taxes,¹⁵⁰ limiting

a tax is uniform, it would almost certainly violate the apportionment rule. See Jensen, *Consumption Taxes*, *supra* note 94, at 2341–42.

¹⁴⁵ See JENSEN, *THE TAXING POWER*, *supra* note 96, at 77–88.

¹⁴⁶ If the tax is not direct, however, these issues go away (which is what the D.C. Circuit ultimately concluded in *Murphy II*). See *infra* Part VII.

¹⁴⁷ See *infra* Part V.

¹⁴⁸ 3 U.S. (3 Dall.) 171 (1796). The endless series of articles includes Jensen, *Consumption Taxes*, *supra* note 94; Jensen, *How to Read*, *supra* note 112; Jensen, *Interpreting the Sixteenth Amendment*, *supra* note 97; Jensen, *Meaning of Incomes*, *supra* note 19.

¹⁴⁹ U.S. CONST. art. I, § 8, cl. 1.

¹⁵⁰ Morris came to regret the clauses, but he was responsible for them. See Jensen, *Consumption Taxes*, *supra* note 94, at 2386–89.

apportionment “to *direct* taxation. With regard to indirect taxes, on *exports* & imports & on consumption, the rule would be inapplicable.”¹⁵¹

In 1876, Judge Cooley drew a distinction that, for the most part, Gouverneur Morris would have understood. Taxes are

Direct, under which designation would be included those which are assessed upon the property, person, business, income, etc., of those who are to pay them; and

Indirect, or those which are levied on commodities before they reach the consumer, and are paid by those upon whom they ultimately fall, not as taxes, but as part of the market price of the commodity. Under the second head may be classed the duties upon imports, and the excise and stamp duties levied upon manufactures.¹⁵²

The “indirect taxes” are generally those the Constitution denominated “duties, imposts, and excises,” and in general are taxes imposed on articles of consumption.

Cooley did not say his distinction was constitutionally mandated, but I suspect he would have had *Hylton* not been on the books.¹⁵³ The distinction occurs throughout the Founding debates. For example, in *Federalist* 36, Alexander Hamilton wrote that by “indirect taxes” “must be understood duties and excises on articles of consumption.”¹⁵⁴ Direct taxes are everything else.¹⁵⁵

Indirect taxes may wind up affecting the price, and therefore the consumption, of the products to which they relate. In *Federalist* 21,

¹⁵¹ 1 THE RECORDS OF THE FEDERAL CONVENTION OF 1787, at 592 (Max Farrand ed., rev. ed. 1937) (1911) (July 12, 1787). While serving on the Supreme Court, Justice Joseph Story wrote: “[Taxes] are usually divided into two great classes, those, which are direct, and those, which are indirect. Under the former denomination are included taxes on land, or real property, and under the latter, taxes on articles of consumption.” JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 472, at 337–38 (Ronald D. Rotunda & John E. Nowak eds., Carolina Academic Press 1987) (1833); see also *id.* § 473, at 339 (“It is evident, that ‘duties, imposts, and excises’ are indirect taxes in the sense of the constitution.”).

¹⁵² THOMAS M. COOLEY, A TREATISE ON THE LAW OF TAXATION 5 (1876).

¹⁵³ In a footnote, Cooley wrote, “The term ‘direct taxes’ is employed in a peculiar sense in the federal constitution in the provision requiring such taxes to be apportioned according to representation, and they are, perhaps, limited to capitation and land taxes.” *Id.* at 5 n.2 (citing, *inter alia*, *Hylton v. United States*, 3 U.S. (3 Dall.) 171 (1796)). I interpret the “perhaps” as acknowledging precedent, but questioning its merits.

¹⁵⁴ THE FEDERALIST NO. 36, at 219 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

¹⁵⁵ Some have wondered whether levies might exist that are neither direct (governed by the apportionment rule) nor indirect (subject to uniformity requirements). See, e.g., STORY, *supra* note 151, § 473, at 339. No such levy has been identified, however. See Jensen, *Consumption Taxes*, *supra* note 94, at 2341–42.

Hamilton noted that “[i]mposts, excises, and, in general, all duties upon articles of consumption, may be compared to a fluid, which will in time find its level with the means of paying them.”¹⁵⁶ Consumers will adjust their behavior to the cost of the products, including the taxes—the “imperceptible agency of taxes on consumption.”¹⁵⁷ The assumption of most Founders was that regardless of the party on whom an indirect tax was in form laid—an importer, perhaps, or a seller—the burden was shifted to the ultimate consumer.¹⁵⁸ That person could decide, in making his purchasing decision, whether to be subject to the tax.

Because the consumer can avoid an indirect tax by not buying the taxed product, the market itself prevents governmental overreaching. The government needs revenue, and it has no incentive to raise taxes to levels so oppressive that revenue would actually decrease. If a taxpayer thinks an impost on imported silk is too high, he can buy some other, untaxed product instead, and the government gets nothing. Importers and sellers adjust as well. As Anti-Federalist Brutus explained, “[I]f [imposts] are laid higher than trade will bear, the merchants will cease importing, or smuggle their goods. We have therefore sufficient security, arising from the nature of the thing, against burdensome and intolerable impositions from this kind of tax.”¹⁵⁹

Self-policing as they are, indirect taxes required no constitutional limitations beyond the uniformity rule, as Brutus noted. That is why Gouverneur Morris limited the apportionment rule to direct taxes, which have no similar built-in protection. In general, direct taxes are imposed on individuals (as contrasted with a tax on sale, importation, or transfer of a product) in a way that prevents shifting the burden to someone else. At an abstract level, any tax can be avoided, but one cannot avoid a capitation tax or a tax on real estate as easily as one can an indirect tax.

It was because government can more easily abuse direct taxes that many Founders wanted explicit restraint on their use. The concern

¹⁵⁶ THE FEDERALIST NO. 21 (Alexander Hamilton), *supra* note 154, at 142.

¹⁵⁷ THE FEDERALIST NO. 12 (Alexander Hamilton), *supra* note 154, at 93.

¹⁵⁸ It is not necessarily true that the burden of an indirect tax can be passed on: “It is not always possible to raise the price of a commodity in exact proportion to every additional imposition laid upon it. The merchant . . . is often under a necessity of keeping prices down in order to make a more expeditious sale.” THE FEDERALIST NO. 35 (Alexander Hamilton), *supra* note 154, at 212. But, as Hamilton observed, “[t]he maxim that the consumer is the payer is so much oftener true than the reverse of the proposition.” *Id.*

¹⁵⁹ Essays of Brutus, No. 5 (Dec. 13, 1787), reprinted in 2 THE COMPLETE ANTI-FEDERALIST 388, 392–93 (Herbert J. Storing ed., 1981). Smuggling is not a permissible form of tax avoidance, see Lawrence Zelenak, Essay, *Radical Tax Reform, the Constitution, and the Conscientious Legislator*, 99 COLUM. L. REV. 833, 839 (1999), but ceasing importation is.

with direct taxes was partly that individuals could be harmed by an overzealous national government. But it was also that direct taxation could soak up so much revenue that little would be left to fund state needs.¹⁶⁰ That danger had not existed with the requisitions used, often unsuccessfully, to raise revenue under the Articles of Confederation. When the national government, such as it was, requisitioned revenue from the states, the states served as filters of national power and protectors of their own interests—and thus protectors of their residents. Direct taxes, which would reach individuals directly, were different.¹⁶¹

Is the individual income tax a direct tax, so understood? Absolutely. The tax is imposed on individuals, in a way that is as different from requisitions as can be, and the tax is not avoidable in the same manner as an indirect tax.¹⁶² An income tax has the dangers that apportionment was intended to protect against, and it should matter not a whit that the Founders did not explicitly characterize an income tax as a direct tax. One should not push counterfactuals too hard, but I cannot imagine that the Constitution would have been ratified if there had been a sense in 1789 that something like the modern income tax could be imposed without protections against abuse.¹⁶³

If an income tax is direct, a levy that is part of an unapportioned income tax must, in fact, be a “tax on incomes” if it is to be exempt from apportionment by the Sixteenth Amendment. This is why the constitutional issues in *Murphy* were potentially significant.

But even if an income tax is generally direct, perhaps there is something special about an income tax as it applies to certain types of income—earned income in particular—that would keep the tax from being classified as direct. To that possibility I now turn.

2. Pollock and a Tax on Earned Income Only

I have concluded that an income tax would have been understood by the Founders as direct, if they had been in an intellectual position

¹⁶⁰ See, e.g., Essays of Brutus, No. 1 (Oct. 18, 1787), reprinted in COMPLETE ANTI-FEDERALIST, *supra* note 159, at 363, 366 (“[W]hen the [federal] government begins to exercise the right of taxation in all its parts, the legislatures of the several states will find it impossible to raise monies to support their governments.”).

¹⁶¹ But see Joseph M. Dodge, *What Federal Taxes Are Subject to the Rule of Apportionment Under the Constitution?*, 11 U. PA. J. CONST. L. 839 (2009) (arguing that, together with capitation taxes and taxes on tangible property, requisitions are direct taxes).

¹⁶² Of course, an individual can avoid an income tax by having no income, or a capitation tax by committing suicide. But avoiding these taxes requires discombobulating one’s life much more than avoiding an indirect tax would.

¹⁶³ See Jensen, *How to Read*, *supra* note 112, at 689.

to think about an income tax in the first place. I therefore have also implicitly concluded that *Pollock* was rightly decided. If a tax would be considered direct under *Pollock*, it could be enacted today in an unapportioned form only if it is a "tax on incomes," which is why there was a potentially serious constitutional issue in *Murphy*.

But *Pollock* contains language hinting—more than hinting, with *Springer v. United States*¹⁶⁴ on the books—that a tax which reaches only earned income would be an excise, not a direct tax. An excise would not have to be apportioned even in a world with no Sixteenth Amendment. If earned income is fundamentally different from income from property, perhaps a tax on an emotional-distress recovery, likened by many to a tax on wages,¹⁶⁵ would not be direct either. If so, we need not consider whether the levy on Ms. Murphy's recovery is a "tax on incomes."

In *Springer*, the Supreme Court upheld the Civil War income tax against a challenge that it was an unapportioned direct tax: "[D]irect taxes, within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate"¹⁶⁶ And, said the Court, the income tax was "within the category of an excise or duty."¹⁶⁷

That the tax as it applied to Springer himself was heavily on earned income apparently played no role in the Court's decision; the *Hylton* dictum was decisive. But the *Pollock* Court examined the *Springer* record to conclude that, although the tax could have reached income from property, little or none of Springer's income had come from that source.¹⁶⁸ And that fact might have justified treating the tax as it applied to Springer as an excise.¹⁶⁹

We ought to be skeptical when a court characterizes a decision as

¹⁶⁴ 102 U.S. 586 (1881).

¹⁶⁵ See *infra* Part VI.E.

¹⁶⁶ *Springer*, 102 U.S. at 602.

¹⁶⁷ *Id.* (citations omitted).

¹⁶⁸ The Court stated:

The . . . record discloses that [Springer's] income was not derived in any degree from real estate but was in part professional as attorney-at-law and the rest interest on United States bonds. It would seem probable that the court did not feel called upon to advert to the distinction between the latter and the former source of income, as the validity of the tax as to either would sustain the action.

Pollock v. Farmers' Loan & Trust Co. (Pollock I), 157 U.S. 429, 578–79, *modified on reh'g*, 158 U.S. 601 (1895). The Court also noted that "a tax on professional receipts might be treated as an excise or duty, and therefore indirect, when a tax on the income of personality might be held to be direct." *Id.* at 579.

¹⁶⁹ If the aggrieved taxpayer had substantial income from property, the *Springer* Court therefore might have invalidated the Civil War income tax—or so the Court implied in 1895. See *id.*

standing for something it clearly did not. But treating *Springer* as involving a tax on earned income provided a way for the *Pollock* Court to overturn the 1894 tax without repudiating precedent.¹⁷⁰ If a levy on income from “professions, trades, employments, or vocations” was an excise,¹⁷¹ the only issue in *Pollock* was whether a tax on income from property could be imposed without apportionment: “[I]n the case before us there is no question as to the validity of this act, except [the] sections . . . which relate to the subject which has been under discussion,” taxing income from property.¹⁷²

Applying the syllogism outlined earlier, the *Pollock* Court concluded that a tax on income from property was direct. With a little extrapolation to treat income from personal property the same as income from real property, the Court came to a result consistent with *Hylton*¹⁷³:

We have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax and been sustained as such.¹⁷⁴

Taxing income from property was the point of the unapportioned 1894 tax. For the high-income folks at whom the tax was directed, earned income was also part of the base, however, and the Court concluded it was impossible to sever the tax on earned income from the critically important levy on income from property. If the whole statute did not fall, “what was intended as a tax on capital” would have been turned into “in substance a tax on occupations and labor.”¹⁷⁵

¹⁷⁰ See *id.* at 578–79.

¹⁷¹ *Pollock II*, 158 U.S. at 637.

¹⁷² *Id.* at 635; see also 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 1.2.2, at 1–19 (3d ed. 1999) (noting intimation “that a tax on salaries, wages, and business profits would not be a direct tax”).

¹⁷³ See *supra* note 115 and accompanying text.

¹⁷⁴ *Pollock II*, 158 U.S. at 635.

¹⁷⁵ *Id.* at 637. The Court further stated:

[I]t is evident that the income from realty formed a vital part of the scheme for taxation embodied therein. If that be stricken out, and also the income from all invested personal property, bonds, stocks, investments of all kinds, it is obvious that by far the largest part of the anticipated revenue would be eliminated, and this would leave the burden of the tax to be borne by professions, trades, employments, or

For most purposes today, it does not matter whether a tax on earned income is direct or not. As long as it is “on incomes,” a tax does not need to be apportioned, whatever the source of the income. But if Ms. Murphy’s emotional-distress recovery was properly included in gross income under section 61 of the Internal Revenue Code, the subject of the next part of this Article, the status of this particular levy—whether it was “on incomes” or not—continues to matter.

As I discussed earlier, I have no doubt that a tax on an emotional-distress recovery is direct, and that it would be permissible in unapportioned form only if the recovery is “incomes” within the meaning of the Sixteenth Amendment. I shall discuss later why an emotional-distress recovery is not the equivalent of wages and why, therefore, any special treatment for earned income that might be found in *Pollock* should not extend to such a recovery.¹⁷⁶ (The D.C. Circuit ultimately concluded in *Murphy II* that the levy was an excise, noting that the *Pollock* Court had said “a tax upon income from employment” is an excise.¹⁷⁷)

More important, however, I am doubtful that the passages in *Pollock* dealing with a tax on earned income should be given weight. Supreme Court dicta are important, and these dicta are cited regularly in commentary on *Pollock*. But there are at least two reasons to be skeptical about their continuing significance. First, let us not forget that the Court struck down the tax as it applied to earned income. The entire tax was invalidated, and “not comment[ing] on” the treatment of earned income (language from *Pollock*) is not a ringing endorsement of *Springer*.¹⁷⁸ Second, given the distinction between direct and indirect taxes outlined earlier,¹⁷⁹ I see no reason to characterize income from property and income from services differently. A tax on either is direct—on individuals, not easily avoidable, unlike requisitions, and so on.

Springer was the result of unthinkingly applying one *Hylton* dictum: the Founders did not say an income tax is direct, and therefore it is not direct. What the *Pollock* Court did was rethink the

vocations; and in that way what was intended as a tax on capital would remain in substance a tax on occupations and labor.

Id. at 636–37.

¹⁷⁶ See *infra* Part VI.E.

¹⁷⁷ *Murphy II*, 493 F.3d 170, 184 (D.C. Cir. 2007) (citing *Pollock II*, 158 U.S. at 635), *cert. denied*, 553 U.S. 1004 (2008).

¹⁷⁸ See *supra* text accompanying note 174.

¹⁷⁹ See *supra* Part IV.C.1.

original meaning of “direct tax.” In doing so, it cut the heart out of *Springer*, while leaving to others preparation of the death certificate.

I hypothesize that members of the *Pollock* majority were thinking as follows: *Pollock* was going to be a noteworthy, unpopular decision.¹⁸⁰ If the majority could tie its conclusion to precedent, damage might be contained. Focusing on income from property provided the link to *Hylton*,¹⁸¹ and suggesting that a tax on earned income might be treated differently obviated any need to overturn *Springer*—as that case had been reinterpreted—while still striking down the tax. The result was seen by the public as radical, but in form the Court adhered to precedent. In addition, with no political inclination at the time to enact a tax on earned income only—the point of the income tax was to reach the wealthy’s income from property¹⁸²—the treatment of earned income in *Pollock* really did not seem important. Why sweat the small stuff?

My conclusion is that a tax on earned income is as direct as a tax on income from property. But even if I am wrong about this, I see no reason why a tax on a recovery for emotional distress should be characterized as indirect. It is not a shiftable tax; it cannot be easily avoided by the taxpayer (except by not seeking damages to begin with). And, as I shall argue later, wages and emotional-distress recoveries need not be seen as functional equivalents.

D. The Constitution Matters in Murphy—and in Taxation Generally

No reader needs to agree with a significant percentage of the points made above to agree with my conclusion: there are serious constitutional issues in *Murphy* that commentators ignored in the rush to condemn the result in *Murphy I*. The tax on the emotional-distress recovery might well have been direct, and, if so, it was critical for the tax to be treated as one “on incomes.” Before returning to the constitutional issues, however, I turn to the Internal Revenue Code, and what it says—or does not say—about emotional-distress recoveries.

V. SECTION 104(A)(2) AND NONPHYSICAL PERSONAL INJURIES

Murphy was not just a constitutional case. In this part of the Article, I address the workings of section 104(a)(2) of the Internal

¹⁸⁰ One prominent critic noted that *Pollock* had been characterized as the “the Dred Scott decision of government revenue.” See EDWIN R.A. SELIGMAN, *THE INCOME TAX* 589 (2d ed. 1914) (1911).

¹⁸¹ See *supra* note 115 and accompanying text.

¹⁸² See Jensen, *Meaning of Incomes*, *supra* note 19, at 1091–1107.

Revenue Code, which was initially struck down on constitutional grounds in *Murphy I*.¹⁸³ The issues for present purposes are these: How did the 1996 amendment of section 104(a)(2) change the way we should think about whether a recovery for personal injuries is taxable or not? Is it unquestionably the case that, as many have argued, a recovery for a nonphysical personal injury is taxable in full to the recipient?

The constitutional issues considered in *Murphy* need to be addressed only if a recovery is taxable under the statutory scheme. I submit that the conventional wisdom—that a recovery for a nonphysical personal injury is automatically taxable¹⁸⁴—is not right. It cannot be right, and that should cause us to examine *Murphy*-like recoveries carefully.

A. The 1996 Amendment to Section 104(a)(2)

In 1996, Congress amended section 104(a)(2), which had provided an exclusion for recoveries received on account of any personal injuries or sickness, to limit the exclusion to recoveries for *physical* personal injuries or sickness and to provide that “emotional distress shall not be treated as a physical injury or physical sickness.”¹⁸⁵ The conventional wisdom is that, after the amendment, a recovery for a nonphysical personal injury is taxable, period, unless it can be tied to a physical injury.¹⁸⁶ (If the recovery is deemed to be “on account of” a physical injury, however, the entire amount, with a couple of exceptions, is excluded from gross income.¹⁸⁷) If that is right, once

¹⁸³ 460 F.3d 79, 81 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

¹⁸⁴ See, e.g., Gregg D. Polsky & Brant J. Hellwig, *Taxing Structured Settlements*, 51 B.C. L. REV. 39, 74 (2010) (“As a result [of the statutory change], damages received on account of a non-physical injury now are fully taxable.”).

¹⁸⁵ Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(b), 110 Stat. 1755, 1838 (1996) (codified at I.R.C. § 104(a)(2) (2006)).

¹⁸⁶ See, e.g., Germain, *supra* note 29, at 208 (“If emotional injury recoveries were not included in ‘income,’ the amendment to I.R.C. § 104(a)(2) would be substantially superfluous.”). But the amendment made it clear only that a lost-profits or lost-wages component of any recovery would be taxable. That was not a superfluous change, regardless of how any additional recovery might be treated.

¹⁸⁷ The exclusion has never applied to a recovery of medical expenses that had already been paid and deducted. See I.R.C. § 104(a). Application of the exclusion to punitive damages associated with a personal injury (i.e., amounts not even arguably compensatory) used to be a matter of doubt, but, after the 1996 amendments, it is clear that punitives are taxable regardless of the nature of the underlying claim. See I.R.C. § 104(a)(2) (creating an exclusion for damages “other than punitive damages”). Indeed, it should have been clear under prior law. See *O’Gilvie v. United States*, 519 U.S. 79, 81 (1996) (holding that punitives were not received “on account of” personal injury under a prior version of section 104(a)(2)). But see *id.* at 94 (Scalia, J., dissenting) (arguing that the “any damages” language included punitives). The exception for punitives is easy to apply when a verdict specifies a particular amount. With a settlement,

Ms. Murphy's recovery was determined not to have been due to a physical injury, section 104(a)(2) was inapplicable, and she was left with only her argument under the Sixteenth Amendment.

Indeed, the conference committee report on the 1996 amendment contains headings that seem to instruct individuals to "[i]nclude in income damage recoveries for nonphysical injuries," as if that were the result of the statutory changes.¹⁸⁸ Courts have assumed that to be the case. In recent litigation, the Tax Court has routinely concluded that, if no physical injury is involved, a recovery is fully taxable.¹⁸⁹ District courts, including Judge Lamberth in *Murphy*, have made the same assumption,¹⁹⁰ and appellate courts have agreed.¹⁹¹ Indeed,

however, one can imagine negotiators taking the possibility of punitives into account. If the settlement amount for a physical injury is bumped up, should part of it be includable in gross income? The conceptually right answer is yes, and the Service has taken that position. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2009-03-073 (Oct. 9, 2008) (specifying that section 104(a)(2) exclusion would be inapplicable to the portion of a settlement attributable to punitives). As a practical matter, however, it is hard to see how this issue can be policed. (One justification for the broad exclusion for physical injury recoveries is the difficulty of breaking a recovery into components, some perhaps taxable without section 104(a)(2), some not.)

¹⁸⁸ H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.), *reprinted in* 1996-3 C.B. 741, 1041.

¹⁸⁹ *See, e.g.*, *Hennessey v. Comm'r*, 2009 T.C.M. (RIA) 1089 (2009). *Hennessey* involved a class action settlement paid to Air Force officers who were involuntarily separated due to a reduction in force. *Id.* at 1090 & n.3. *Hennessey* argued his recovery was, at least in part, not income because there was no accession to wealth (e.g., compensation for the stigma of involuntary separation), *id.* at 1091, but the court rejected the argument summarily, citing *Murphy II* to the effect that "taxation of awards received for personal, nonphysical injuries was within the power of Congress." *Id.* at 1091-92 (citing *Murphy II*, 493 F.3d 170, 173 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008)). The Tax Court in *Venable v. Commissioner*, 86 T.C.M. (CCH) 254 (2003), *aff'd*, 110 F. App'x 421 (5th Cir. 2004) (per curiam), also held that the recovery was fully taxable. *Venable* involved a recovery for malicious prosecution, including amounts for lost earning capacity, mental anguish, and loss to reputation. *Id.* at 255. The narrow issue was whether the change in section 104(a)(2) applied to a 1998 recovery in a suit begun in 1994. The Tax Court answered this question in the affirmative, but did not consider whether part of the recovery might have been tax-free anyway. *Id.* at 259; *see also* *Pettit v. Comm'r*, 95 T.C.M. (CCH) 1341, 1344 (2008) (holding recovery in an employment dispute taxable because it does not qualify for the 104(a)(2) exclusion); *Seidel v. Comm'r*, 93 T.C.M. (CCH) 938, 940 (2007) (holding that the settlement agreement in an unemployment dispute was taxable because it did not fall under the 104(a)(2) exclusion). In *Phelps v. Commissioner*, 95 T.C.M. (CCH) 1336 (2008), the Tax Court concluded that a recovery under Title VII of the Civil Rights Act of 1964 was "not received on account of tort-like personal injuries, let alone tort-like personal physical injuries" and was therefore taxable. *Id.* at 1341.

¹⁹⁰ Judge Lambreth wrote, "[T]he revised language of § 104(a)(2) indicates that only physical injuries and physical sickness [sic] are exempted from the definition of 'income.' Therefore, anything falling outside this definition is considered income, and is therefore taxable." *Murphy v. IRS*, 362 F. Supp. 2d 206, 218 (D.D.C. 2005) (emphases added) (citing *United States v. Burke*, 504 U.S. 229, 248 (1992), which stated that "exclusions from income must be narrowly construed"), *aff'd*, 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008); *see also id.* at 215 ("Because plaintiff's \$25,000 of compensatory damages was based on damage to Murphy's professional reputation, this award is not specifically exempted by statute, and thus falls within the broader definition of gross income." (emphasis added)).

¹⁹¹ *See, e.g.*, *Allum v. Comm'r*, 2007-1 U.S.T.C. (CCH) ¶ 50,489, ¶ 50,490 (9th Cir.)

the *Murphy II* panel ultimately concluded that the recovery was taxable even if Ms. Murphy had realized no accession to wealth.¹⁹²

I question those assumptions. I shall argue that, whatever Congress might have been thinking when it amended section 104(a)(2), it cannot possibly be the case that all recoveries for nonphysical personal injuries are taxable. Most yes, but not all. At a minimum, the interpretive questions are more difficult than the conventional wisdom suggests, and that fact should have relevance to how we think about cases like *Murphy*.

When Congress changed the rules governing nonphysical personal injuries, it was responding to widely publicized Supreme Court cases where the question had been whether recoveries for a nonphysical injury, such as one under the Age Discrimination in Employment Act or one for sex discrimination, should have been treated as “received on account of [a] *personal injury*” and thus excludable under the old version of section 104(a)(2).¹⁹³ With no physical-nonphysical distinction built into the statute, the arguments for exclusion were not baseless. Longstanding regulations, still on the books, had defined a personal injury recovery as arising from “tort or tort type rights,”¹⁹⁴ and many torts lead to no physical damage.

Nevertheless, if a recovery simply replaces something that would have been taxable anyway, like lost wages, full exclusion did not seem to be the right result. And the Supreme Court concluded the recoveries in the discrimination cases should be taxable. (That situation seemed no different from recovery in a breach-of-contract case.¹⁹⁵) Putting aside litigation costs (that is, assuming away the real world, as we do in law review articles); assuming that the amount

(unpublished) (concluding that “[t]he tax court properly determined that the settlement . . . was not excludable from [taxpayer’s] taxable income because it was received as settlement for violation of his civil rights, not physical injury or sickness”), *cert. denied*, 552 U.S. 926 (2007).

¹⁹² *Murphy II*, 493 F.3d at 179–80; *see also infra* Part VII.

¹⁹³ *Comm’r v. Schleier*, 515 U.S. 323, 332 (1995) (holding ADEA recoveries taxable because “not ‘received ‘on account of personal injury [*sic*] or sickness’” (internal quotation marks omitted)); *United States v. Burke*, 504 U.S. 229, 241 (1992) (holding Title VII recoveries taxable for the same reason).

¹⁹⁴ Treas. Reg. § 1.104-1(c) (2009). A regulation proposed in September 2009 will, if finalized, remove the reference to “tort or tort type rights.” The proposal is intended to expand the scope of the exclusion, but it would leave us with no definition of “personal injury.” *See* Damages Received on Account of Personal Physical Injuries or Physical Sickness, 74 Fed. Reg. 47,152 (Sept. 15, 2009) (to be codified at 26 C.F.R. pt. 1) (promulgating Prop. Reg. § 1.104-1(c)); Erik M. Jensen, *Parsing the Meaning of “Personal Injuries” Under Section 104(a)(2)*, J. TAX’N INV., Winter 2010, at 92.

¹⁹⁵ Whether or not it is the right result conceptually, Congress did provide for full exclusion for a recovery on account of personal *physical* injuries, which is why section 104(a)(2) is significant.

of any recovery is unaffected by taxability;¹⁹⁶ and assuming full compensation is received for lost wages, a personal injury plaintiff would be better off with a tax-free recovery than if no injury had occurred to begin with. Replacing a taxable salary of \$100,000 with a tax-free recovery of \$100,000 seems too good to be true.¹⁹⁷ If that is the law, volunteering to be a personal injury victim might be a good tax-planning device.¹⁹⁸

Hence the statutory change, which was intended to deal with the recovery-of-lost-profits situation involved in the high-profile discrimination cases. The conference committee report on the 1996 legislation notes the concern Congress was addressing:

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits.¹⁹⁹

The goal is to make the injured party whole, not to make her more than whole. If all that is involved is compensation for lost wages or

¹⁹⁶ Continue to assume away the real world. One might question whether jurors are aware of the tax consequences of recoveries, see Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 55–64 (1987), but plaintiffs and defendants consider taxation in settlement talks. See *Eshelman v. Agere Sys., Inc.*, 554 F.3d 426, 442 (3d Cir. 2009) (affirming a decision that, to make plaintiff whole, had granted an additional award to take into account the negative result of being paid a lump sum). Professor Dodge notes that, with a full-fledged exclusion, “a compensation regime that ignores the effect of taxes has the effect of overcompensating plaintiffs, while taking taxes into account converts a potential plaintiff windfall into a reduction in the amount that the defendant must pay.” Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 146 n.20 (1992) [hereinafter Dodge, *Taxes and Torts*]. State tort law—should the compensatory amount take into account taxability?—and federal tax law are inextricably linked.

¹⁹⁷ Cf. *O’Gilvie v. United States*, 519 U.S. 79, 86 (1996) (“[T]he provision can make the compensated taxpayer better off from a tax perspective than had the personal injury not taken place.”).

¹⁹⁸ I am kidding, sort of, although favorable tax treatment would generate more discrimination litigation. Cf. Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 26 (1984) (arguing with tongue in cheek that, if accrual-basis taxpayers may deduct an undiscounted amount of future liabilities, “well-advised accrual-method businesses should cancel their liability insurance and run down pedestrians at the rate of at least one a year”).

¹⁹⁹ H.R. REP. NO. 104-737, at 300 (1996) (Conf. Rep.), reprinted in 1996-3 C.B. 741, 1040.

lost profits, the recovery ought to be taxable.

At one level the change was unnecessary. The Supreme Court had concluded that no “tort or tort type right” was involved when only a recovery for lost wages or profits was available: “one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff.”²⁰⁰ With no “personal injury,” section 104(a)(2), even in its pre-1996 Act form, was not implicated. But the statutory change presumably made characterization issues easier—making physical versus nonphysical injuries the generally decisive distinction, rather than having to differentiate between torts and other sorts of wrongs.²⁰¹

After the 1996 Act, two things are clear: nonphysical personal injury recoveries that compensate only for lost wages or profits are taxable,²⁰² as are awards that, like punitive damages, are merely windfalls.²⁰³ But it is not so obvious that a recovery for a *nonphysical* personal injury necessarily compensates only for otherwise taxable items or is just a windfall. That might generally be the case, but it is not necessarily so.²⁰⁴ If something other than lost profits is involved, there might be an argument for excluding all or part of a recovery—using a rationale independent of section 104(a)(2).

Whatever the staff was thinking in drafting reports about the 1996 Act, automatic taxability is mandated by neither the statute nor common sense. We should interpret changes to section 104(a)(2) in light of Congress’s concerns—awards of lost wages or lost profits—and not cram all nonphysical recoveries into a conceptual system designed for a more limited purpose.

²⁰⁰ *United States v. Burke*, 504 U.S. 229, 234–35 (1992). A proposed regulation would do away with the idea that section 104(a)(2) is inapplicable unless a broad range of remedies is available. *See* Prop. Treas. Reg. § 1.104-1(c)(2), 74 Fed. Reg. 47,152, 47,153–54 (Sept. 15, 2009).

²⁰¹ With a recovery for lost profits, it is unnecessary to determine whether the injury is “personal” if the injury is nonphysical. No exclusion applies, and the recovery is taxable.

²⁰² *See* I.R.C. § 104(a) (2006). Recoveries for physical injuries are likely to have a lost-income component too, but the probability is higher that other elements will be included. Exclusion obviates the need to break recoveries into taxable and nontaxable parts. Professor Dodge argues that difficulty of characterization points toward full taxation. *See* Dodge, *Taxes and Torts*, *supra* note 196, at 150. I disagree. *See infra* Part V.B (explaining that automatic inclusion of recoveries for nonphysical injuries is bizarre).

²⁰³ *See* I.R.C. § 104(a).

²⁰⁴ Indeed, the Supreme Court intimated that, if the only remedy is recovery of lost profits or wages, the injury is not personal. *See Burke*, 504 U.S. at 234–35; *supra* text accompanying note 200.

B. Why Automatic Taxability Makes No Sense

Congress might have assumed it was making nonphysical recoveries taxable, but the assumption was not the result of careful thought. Congress could not have meant, in its institutional heart of hearts, to make all such recoveries taxable, and the amended statutory structure does not mandate that result.

1. Basis-Recovery Cases

At a minimum, the amendment to section 104(a)(2) cannot have been intended to make taxable a personal injury award that is merely the recovery of basis—at least not if we are talking about an *income* tax. In such a case, there is no income to tax.²⁰⁵

Sometimes people (read law students) assume that, if a person receives cash, he must pay income tax on that receipt. But, if we think about the matter for a nanosecond, we know that assumption is much too broad. For example, if someone sells a widget for \$100 that he purchased for \$100, he has no gain and therefore no income. (Taxing that \$100 would effectively turn the tax into one on gross receipts.²⁰⁶) If no gain results, despite what the government argued in *Murphy I*, it does not matter that the taxpayer converted his property into cash.²⁰⁷

This point—that what are in effect basis-recovery situations should not be taxable under an income tax—might seem obvious. Indeed, it is obvious, which is why the general understanding of the effect of the amendment to section 104(a)(2) is so obviously wrong: *a recovery for a nonphysical personal injury that constitutes nothing but recovery of basis does not become taxable just because Congress narrowed the exclusion in section 104(a)(2)*.

Consider the widely-noted 1939 decision in *Clark v. Commissioner*,²⁰⁸ where a tax lawyer reimbursed a couple because the lawyer had made a mistake and, as a result, the couple had paid about \$20,000 too much in federal income taxes. The Board of Tax Appeals concluded the recovery was not taxable to the Clarks, and the Commissioner later acquiesced in *Clark*.

²⁰⁵ Professor Dodge disagrees that netting is required to have an income tax, but he accepts the idea that recoveries representing recovery of basis should be tax free. See Dodge, *Netting of Costs*, *supra* note 70.

²⁰⁶ Cf. SELIGMAN, *supra* note 180, at 19 (noting that “[i]ncome is . . . to be distinguished from mere receipts or gross revenue. . . . By income is always meant net income, as opposed to gross income.”). The goal of the Sixteenth Amendment was to reach higher-income, not no-income, persons.

²⁰⁷ See *supra* notes 78–80 and accompanying text (criticizing contrary position taken by the government in *Murphy I*).

²⁰⁸ 40 B.T.A. 333 (1939), *acq.*, 1957-1 C.B. 4.

In support of its conclusion, the Board stated,

It has been held that payments in settlement of an action for breach of promise to marry are not income. *Lyde McDonald*, 9 B.T.A. 1340. Compromise payments in settlement of an action for damages against a bank on account of conduct impairing the taxpayer's good will by injuring its reputation are also not taxable. *Farmers & Merchants Bank of Catlettsburg, Ky. v. Commissioner*, 59 Fed. (2d) 912. The same result follows in the case of payments in settlement for injuries caused by libel and slander. *C. A. Hawkins*, 6 B.T.A. 1023. Damages for personal injury are likewise not income. *Theodate Pope Riddle*, 27 B.T.A. 1339.²⁰⁹

That string of citations illustrates that, in the early years of the income tax, many folks assumed that certain recoveries for losses did not constitute income—at least statutorily—and that judicial and regulatory authority supported that assumption.

I will return to the question of the continuing vitality of those old cases,²¹⁰ but even if they have fallen by the wayside—the understanding of income in *Clark* was narrower than that set out by the Supreme Court in 1955 in *Commissioner v. Glenshaw Glass Co.*²¹¹—the result in *Clark* made sense. The couple was compensated for a loss that generated no tax benefit: the Clarks could not have deducted the extra federal income taxes they had paid.²¹² After taking the effect of taxes into account, the Clarks had lost the full \$20,000. If they were to be made whole, untaxed dollars had to replace the \$20,000 of nondeductible dollars paid out earlier. When the dust had settled, the tax results should have been the same as if no injury had

²⁰⁹ *Id.* at 335.

²¹⁰ See *infra* Parts V.B.2 to V.B.3.

²¹¹ 348 U.S. 426 (1955) (holding that antitrust treble damages and punitive damages are includable in “gross income”). The Board in *Clark* had said that the theory behind cases holding that personal injury (and related) recoveries were not taxable was

that recoupment on account of such losses is not income since it is not “derived from capital, from labor or from both combined.” And the fact that the payment of the compensation for such loss was voluntary, as here, does not change its exempt status. It was, in fact, compensation for a loss which impaired petitioner's capital.

Clark, 40 B.T.A. at 335 (citations omitted). But the Court in *Glenshaw Glass* concluded that “income” includes “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion”—even if not derived from labor or capital. *Glenshaw Glass*, 348 U.S. at 431.

²¹² Cf. I.R.C. § 275(a) (2006) (setting out the principle today that federal taxes are not deductible).

occurred.²¹³ As the Board noted, this was “compensation for a loss which impaired petitioner’s capital”;²¹⁴ the reimbursement from the lawyer was equivalent to a recovery of basis.²¹⁵

For that reason, regardless of whether the old cases cited by the Board remain valid today, most commentators think *Clark* was rightly decided. There was, to use the language of *Glenshaw Glass*, no “accession to wealth.”²¹⁶ And *Clark* became the law, accepted (albeit grudgingly, eighteen years later) by the Internal Revenue Service.

Let us think about how the changes to section 104(a)(2) would affect the *Clark* analysis today. The Clarks did not have to sue the tax lawyer—as a member of a noble profession, he voluntarily compensated the Clarks for his mistake—but suppose the Clarks had sued for malpractice and recovered \$20,000. In many jurisdictions, legal malpractice sounds in tort, which probably means it is a personal injury—based on a “tort or tort type right”—for purposes of section 104(a)(2).²¹⁷ But surely legal malpractice is not a *physical* injury—at least not if the claim that gave rise to the malpractice had no physical component to it, as was true in *Clark*. Would such a recovery, resulting from a lawsuit or a settlement in lieu of a lawsuit,²¹⁸ therefore have to be taxable in a post-1996 world, with amended section 104(a)(2) on the books?

That *cannot* be the right result. *Clark* is not the sort of situation

²¹³ Or it is as if, after the mistake was discovered, the Clarks had been able to file an amended return and had received a refund of the \$20,000. Such a refund would not be taxable. See IRS, PUBLICATION 525: TAXABLE AND NONTAXABLE INCOME (2009), available at <http://www.irs.gov/publications/p525/ar02.html> (“Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.”).

²¹⁴ *Clark*, 40 B.T.A. at 335.

²¹⁵ It is presumably important that compensation for the loss came from the responsible party (or an insurer). If *Clark*’s employer had covered the loss caused by the lawyer, we would be talking about compensation for services. Cf. *Old Colony Trust Co. v. Comm’r*, 279 U.S. 716, 729, 731 (1929) (holding that an employer’s payment of an employee’s income taxes constituted taxable income in addition to the employee’s regular compensation). The Service explained *Clark* as follows: “Payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includable in gross income because there is no economic gain.” Rev. Rul. 81-277, 1981-2 C.B. 14, 15 (emphasis added).

²¹⁶ *Glenshaw Glass*, 348 U.S. at 431.

²¹⁷ See Treas. Reg. § 1.104-1(c) (as amended in 1956) (stating that “damages received” for purposes of section 104(a)(2) means “an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights”). If finalized, Proposed Regulation § 1.104-1(c) would expand “personal injury” beyond tort type rights, see Prop. Treas. Reg. § 1.104-1(c)(2), 74 Fed. Reg. 47,152, 47,153–54 (Sept. 15, 2009), but legal malpractice should remain a personal injury.

²¹⁸ Whether a lawsuit was actually filed makes no difference in characterizing a recovery. See Treas. Reg. § 1.104-1(c). If the malpractice was a tort, the settlement is for a personal injury.

Congress was focusing on in amending section 104(a)(2). Moreover, a change in the *Clark* result would be inconsistent with statutory structure. Narrowing the exclusion under section 104(a)(2) becomes an issue only if a recovery would otherwise constitute gross income under section 61. If the recovery was not gross income in *Clark*—if it was in effect a recovery of basis, not “income from whatever source derived”—it does not become gross income simply because the boundaries of an exclusion were narrowed.²¹⁹ Even though a nonphysical personal injury is involved, a *Clark*-type recovery remains excludable from gross income under today’s law.²²⁰ And that should be true whether or not *Eisner v. Macomber*²²¹ is still good law,²²² and regardless of what *Glenshaw Glass* did to old rulings about personal injury recoveries. No accession to wealth, no income.

From the trivial proposition that not every receipt of value is income, a lot follows. To the extent a recovery is not income, a change in the language of section 104(a)(2) should make no difference in the tax treatment. If Congress meant to broaden the outer boundaries of “gross income,” the place to do that was section 61.²²³ Instead, when Congress amended section

²¹⁹ Cf. *United States v. Burke*, 504 U.S. 229, 248 (1992) (Souter, J., concurring) (“[The] default rule of statutory interpretation [is] that exclusions from income must be narrowly construed.” (citing, *inter alia*, *United States v. Centennial Sav. Bank FSB*, 499 U.S. 573, 583–84 (1991))). What I am discussing is whether something would be gross income to begin with, not an exclusion, but narrow construal is still probably appropriate. That is not to say, however, that all receipts of value are taxable.

²²⁰ Section 104(a)(2) must exclude some legal-malpractice recoveries. Suppose a lawyer misses the statute of limitations for filing a physical-injury claim and is sued. The recovery is “on account of” a physical injury, even though the malpractice was not physical. To get that result, we would apply the origin-of-the-claim test, or something similar. See Robert W. Wood, *Tax Treatment of Legal Malpractice Recoveries*, 114 TAX NOTES 665 (2007) (arguing for that result without clear authority); cf. I.R.S. Priv. Ltr. Rul. 2009-03-073 (Oct. 9, 2008) (applying the “origin of claim” or “in lieu of” test to determine the extent to which amounts received from an insurer pursuant to a bad-faith claim, which had been assigned by the insured to the taxpayer who suffered physical injury, would be excludable as “on account of personal physical injury”). The assumption that nonphysical-injury recoveries are taxable again oversimplifies the world. See Robert W. Wood, *IRS Rules Insurance Bad-Faith Recovery Is Tax-Free*, 122 TAX NOTES 1229 (2009) (asking for further guidance on “on account of”).

²²¹ 252 U.S. 189 (1920).

²²² See *supra* notes 129–36 and accompanying text. Of course *Macomber* is still good law! See Jensen, *Meaning of Incomes*, *supra* note 19, at 1133–46; Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 VA. TAX. REV. 1, 56 (1993) (noting that the realization “principle has required refinement . . . [, but] each clarification left the foundation of the principle intact”).

²²³ If Congress was not inclined to change the language of section 61, but wanted to make nonphysical personal injury recoveries taxable, it should have added something to Subtitle A, Chapter 1, Subchapter B, Part II of the Code (titled “Items Specifically Included in Gross Income”)—i.e., sections 71–90. But section 104(a)(2) is in Part III, titled “Items Specifically Excluded from Gross Income.”

104(a)(2), it merely narrowed an exclusion from gross income.²²⁴ A tax professional should not have to look at section 104(a)(2) to determine the consequences of a *Clark*-like recovery.²²⁵

2. Cash Recoveries Outside the Clear Recovery-of-Basis Context

At a minimum, the basis-recovery situation should not be affected by the change in section 104(a)(2), and that by itself is an important point. But it is also true that other nonphysical recoveries were historically understood not to be taxable, whether or not they could be shoehorned into the basis-recovery category. I will use the time-dishonored alienation-of-affections tort to begin making my point.

a. Alienation of Affections and Similar (Silly?) Torts

Robert Wood has written that, as a result of the change in section 104(a)(2), “recoveries for alienation of affections are generally fully taxable under section 61(a).”²²⁶ He might be right, but a long time ago, first in 1922²²⁷ and then in Revenue Ruling 74-77,²²⁸ the tax authorities concluded that such a recovery is tax-free. If your formerly significant other’s affections were alienated, and you were compensated for the reduced affection, Revenue Ruling 74-77 helped dry your tears. The 1974 ruling is worth quoting in its entirety:

An individual taxpayer received certain amounts in settlement of his suit for damages on account of alienation of affections and in consideration for the surrender of the custody of his minor child. These items relate to personal or family rights, not property rights, and may be treated together. None of the amounts received constituted exemplary or punitive damages.

Held, amounts received by the taxpayer as damages for

²²⁴ Because “gross income” under section 61 is what is left after exclusions have been taken into account, narrowing an exclusion does increase the scope of “gross income” as so defined.

²²⁵ A tax professional should be able to rely on statutory structure in doing research. When a new issue arises, she should not have to examine the entire Code—impossible anyway—or the full U.S. Code—really impossible!—to see whether Congress might have put relevant language where it does not belong. Congress may have the power to hide the ball, but the rule of law is strained when that happens.

²²⁶ Robert W. Wood, *Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?*, 105 TAX NOTES 68, 70 (2004). I think Wood’s use of “generally” was intended to pick up a situation in which alienation of affections is linked to a physical injury claim.

²²⁷ Sol. Op. 132, 1-1 C.B. 92 (1922).

²²⁸ Rev. Rul. 74-77, 1974-1 C.B. 33.

alienation of affections or for the surrender of the custody of his child, whether under agreement of the parties or pursuant to judgment of the court, are not income.

Sol. Op. 132, I-1 C.B. 92 (1922), is hereby superseded since the position stated therein is set forth under the current statute and regulations in this Revenue Ruling.²²⁹

“Not income”! What was striking about the ruling was that, although it was catalogued under section 104 in the bulletin published by the Internal Revenue Service and only cross-referenced under section 61 (the definition of “gross income”), the result did not seem to depend on the old version of section 104(a)(2). The ruling made no mention of that section, nor did it quote or paraphrase language from it.²³⁰ A recovery for alienation of affections, said the Service, was for “personal or family rights”—not the same as a recovery for a “personal injury”²³¹—and “under the current statute and regulations” simply *not income*.

And that conclusion was not surprising. It was consistent with other rulings that the Service had issued in the 1950s and 1960s involving compensation for loss of personal rights in situations where section 104(a)(2) was inapplicable.²³²

The understanding about recoveries for losses of personal rights was one of long standing. The 1922 Solicitor’s Opinion had come to the same conclusion, for the causes of action described in Revenue Ruling 74-77 and also for slander or libel of a personal character:

If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is

²²⁹ *Id.*

²³⁰ When I first wrote about this issue, I failed to note that, although the ruling did not cite section 104(a)(2), or even section 104(a), it was cataloged in the Cumulative Bulletin under “Section 104.—Compensation for Injuries or Sickness.” See Jensen, *Automatically Taxable?*, *supra* note 28. Professor Dodge properly noted my omission, see Dodge, *Recoveries for Nonphysical Injuries*, *supra* note 28, at 986, but then got a lot wrong. He said that “[t]he ruling is listed . . . as being ‘under’ section 104 (not section 61), and the caption refers to 26 CFR 1-104-1 (not any of the section 61 regulations).” *Id.* But right after the citation to section 1.104-1 are cites to sections 61 and 1.61-1. See Rev. Rul. 74-77, 1974-1 C.B. at 33. And the ruling is listed under section 61. *Id.* at 22.

²³¹ *Cf. infra* note 250 (noting that “personal or family rights” was unrelated to section 104(a)(2)).

²³² I shall discuss those rulings presently. See *infra* Part V.B.2.b.

clear, therefore, that the Government can not tax him on any portion of the sum received.²³³

The 1922 opinion reversed an earlier Solicitor's Memorandum that alienation-of-affections recoveries were taxable under the Revenue Act of 1918.²³⁴ The earlier memorandum had concluded that taxation was required because no statutory exception applied,²³⁵ but then, in 1920, the Supreme Court decided *Macomber*,²³⁶ making it clear that a "fundamental" question remained "whether such damages are within the legal definition of income."²³⁷

Few today like *Macomber*, where the Court held that receipt of a proportionate stock dividend was not the receipt of "incomes" under the Sixteenth Amendment.²³⁸ But my argument does not depend on the ultimate rightness of *Macomber*. My point is more limited: it is only that not every receipt of value is income, and that is so even if cash is received.

The Service came to the no-income result in the 1974 ruling nineteen years after the Supreme Court had decided, in *Commissioner v. Glenshaw Glass Co.*,²³⁹ that "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" are taxable (unless Congress says otherwise).²⁴⁰ That language, broadening an earlier definition of income that looked to value derived from labor or capital,²⁴¹ encompassed windfalls like punitives. But a recovery for alienation of affections was still not income.²⁴²

Of course, hardly anyone cares about alienation of affections anymore, unless it happens to you,²⁴³ but I am using the ruling as

²³³ Sol. Op. 132, 1-1 C.B. 92, 93 (1922).

²³⁴ Sol. Mem. 1384, 2 C.B. 71 (1920).

²³⁵ *Id.* at 72. It said the statutory reference to recoveries for "personal injuries" was probably intended to be limited to physical injuries. *Id.* at 71.

²³⁶ 252 U.S. 189 (1920).

²³⁷ Sol. Op. 132, 1-1 C.B. at 93. The opinion also clarified that there was a difference between a purely personal recovery and a recovery for libel that affected business income. The opinion modified Sol. Mem. 957, 1 C.B. 65 (1919), which—pre-*Macomber*—had ruled that any libel recovery is taxable. *See* Sol. Op. 132, 1-1 C.B. at 93–94.

²³⁸ *See* Jensen, *Meaning of Incomes*, *supra* note 19, at 1133–38; *supra* notes 129–36 and accompanying text.

²³⁹ 348 U.S. 426 (1955).

²⁴⁰ *Id.* at 431.

²⁴¹ *See, e.g., Macomber*, 252 U.S. at 207 ("Income may be defined as the gain derived from capital, from labor, or from both combined" (quoting *Stratton's Independence v. Howbert*, 231 U.S. 399, 415 (1913), and *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918))).

²⁴² Although *Glenshaw Glass* has been interpreted in far-reaching ways, the Court did not question that a personal-injury recovery which restores "capital" is not taxable. *See supra* note 75.

²⁴³ But the tort is still recognized in seven states and, on average, 245 suits were filed annually in North Carolina in the 2000–2005 period. *See* Posting of Eugene Volokh to The Volokh Conspiracy, *My Torts Class, and Alienation of Affections*, <http://volokh.com/posts/1249>

an example.²⁴⁴ And the 1974 ruling did not stand alone. Many other decisions had come to the same conclusion: no income, not because of a statutory exclusion, just *no income*.²⁴⁵

On the narrow alienation-of-affections point, I must note that the Service declared Revenue Ruling 74-77 obsolete in 1998.²⁴⁶ A new ruling provided a long list of prior rulings that

are no longer considered determinative because: (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the ruling position is specifically covered by a statute, regulation, or subsequent published position; or (3) the facts set forth no longer exist or are not sufficiently described to permit clear application of the current statute and regulations.²⁴⁷

That is the extent of the explanation, but from the timing one might infer that the Service had concluded Revenue Ruling 74-77 ought to be discarded because of the 1996 change in section 104(a)(2). If that is what the Service was thinking, however, the Service was wrong. The controlling statutory provision in the 1974 ruling was section 61, which, in all relevant respects, was the same in 1998 as in 1974.²⁴⁸ If Revenue Ruling 74-77 required change, it was not because of a statutory amendment, and the purpose underlying the change to section 104(a)(2)—to reach recoveries of lost profits—was not implicated here.²⁴⁹

502730.shtml (Aug. 5, 2009, 16:05 EST). The tort has received some publicity recently because of a threatened suit by Elizabeth Edwards against a political aide of her estranged spouse, former North Carolina Senator and Democratic vice-presidential nominee John Edwards. See Joanna L. Grossman & Lawrence M. Friedman, *Elizabeth Edwards v. Andrew Young: Can He Be Held Liable for Contributing to the Failure of the Edwardses' Marriage?*, FINDLAW, Feb. 19, 2010, <http://writ.news.findlaw.com/grossman/20100219.html>.

²⁴⁴ I am sure that Congress was not thinking of alienation of affections when it amended section 104(a)(2). The focus was on discrimination cases. See *supra* notes 193-201 and accompanying text.

²⁴⁵ See, e.g., *supra* text accompanying note 209 (quoting *Clark v. Comm'r*, 40 B.T.A. 333, 335 (1939), *acq.*, 1957-1 C.B. 4). The *Clark* decision cited to a number of tax cases where the determination was made that no income existed. *Clark*, 40 B.T.A. at 335.

²⁴⁶ Rev. Rul. 98-37, 1998-2 C.B. 133.

²⁴⁷ *Id.* at 133.

²⁴⁸ Revenue Ruling 74-77 had relied on Sol. Op. 132, see *supra* text accompanying note 229, and the Service issued that opinion because of *Macomber*, which few now take seriously. But *Macomber* was just as disfavored in 1974 as in 1998.

²⁴⁹ I can see only one other justification for rendering the 1974 ruling obsolete: affections are now so routinely alienated that the tort has disappeared in most jurisdictions. But see *supra* note 243 (noting that the tort is still recognized in seven states).

b. More Tax-Free Recoveries for Losses of "Personal Rights"

The Internal Revenue Service did revoke the alienation-of-affections ruling after section 104(a)(2) was amended. But what is not widely known is that the Service for several years left on the books other rulings concluding, without clear statutory authority, that certain recoveries of cash were *not income*—because, as with an alienation-of-affections recovery, they were reimbursements for the loss of “personal rights.”²⁵⁰

i. Recoveries by Victims of Persecution

A 1955 ruling, published in a bulletin that also reprinted *Glenshaw Glass*²⁵¹—exquisite timing!—concluded that payments under the War Claims Act of 1948²⁵² to a prisoner of war “are in the nature of reimbursement for the loss of personal rights and are not includible in the gross income of such individual.”²⁵³ A 1956 ruling came to the same conclusion, for the same reasons, with regard to payments made to Korean War prisoners.²⁵⁴ In neither case had Congress said anything about taxability of the reimbursements.

In 1956, the Service ruled that payments by the German government to former German citizens who “were persecuted because of anti-Nazi persuasion or for reasons of race, faith, or philosophy of life, by the National Socialist (Nazi) regime and thereby suffered damage to life, body, health, liberty, rights of property ownership, or to professional or economic advancement” were “in the nature of reimbursement for the deprivation of civil or personal rights and [did] not constitute taxable income.”²⁵⁵ Indeed, with respect to loss of

²⁵⁰ In trying to tie Revenue Ruling 74-77 to section 104(a)(2), see *supra* note 230, Professor Dodge wrote, “The text of the ruling states that the damages were for the violation of a ‘personal’ right, and were compensatory in nature,” and “[t]hat characterization of the facts brings them directly within the then-applicable version of section 104(a)(2).” Dodge, *Recoveries for Nonphysical Injuries*, *supra* note 28, at 986. But the ruling said the damages “relate to personal or family rights, not property rights,” Rev. Ruling 74-77, 1974-1 C.B. 33, and that distinction was not key under regulations. See Treas. Reg. § 1.104-1(c) (as amended in 1956) (defining personal injury in terms of “tort or tort type rights”).

²⁵¹ 348 U.S. 426 (1955), reprinted in 1955-1 C.B. 207.

²⁵² Pub. L. No. 80-896, 62 Stat. 1240.

²⁵³ Rev. Rul. 55-132, 1955-1 C.B. 213.

²⁵⁴ Rev. Rul. 56-462, 1956-2 C.B. 20.

²⁵⁵ Rev. Rul. 56-518, 1956-2 C.B. 25, clarified by Rev. Rul. 57-505, 1957-2 C.B. 50 (specifying German statutes to which the ruling applies and stating that taxability of payments under other statutes “will be decided on the basis of the facts and circumstances involved in each case”) and amplified by Rev. Rul. 58-500, 1958-2 C.B. 21 (discussing the effect of amendments to German statutes). Revenue Ruling 71-477, 1971-2 C.B. 479, noted that these rulings had been rendered moot after 1964 by the United States-Federal Republic Germany Income Tax Convention, 1966-1 C.B. 360 which made such payments to U.S. citizens or residents nontaxable anyway.

property, the ruling concluded, without reference to section 1033,²⁵⁶ that amounts received in excess of basis are not necessarily taxable; taxability “will be determined on the basis of the facts and circumstances of each case.”²⁵⁷ A 1958 ruling came to the same conclusion, for the same reasons, for payments made by the Austrian government.²⁵⁸

Finally, in 1969, the Service ruled that payments of a widow’s pension under Austria’s General Social Insurance Law—as a result of the restoration of benefits of former citizens “if such benefits were placed in jeopardy during the period between March 4, 1933, and May 9, 1945, for political reasons (except for national socialistic acts) or for reasons of religion or race”—“are in the nature of reimbursement for the deprivation of civil or personal rights and do not constitute taxable income.”²⁵⁹

Several things are worth noting. First, none of these rulings was aberrational. This was a series of rulings, over a fifteen-year period after *Glenshaw Glass*, which consistently concluded that certain *cash* recoveries for the loss of “personal rights” were not taxable because they were not income. Furthermore, none relied on, mentioned, or was catalogued under section 104(a)(2), as it then existed. Indeed, none of them would have fit within the language of that section, if the statutory term “personal injuries” is understood to refer to tort-like rights. Instead, all were issued under section 61 or regulations interpreting the meaning of “gross income,”²⁶⁰ and all concluded that recoveries for “personal rights” were not taxable. None had anything to do with recovery of basis, and none fit within the “general welfare exception”—the long-time administrative practice of the Internal Revenue Service not to treat receipts from

²⁵⁶ In any event, the requirements of that section were unlikely to have been satisfied. In general, section 1033 permits a taxpayer to defer gain associated with proceeds from the involuntary conversion of property if, within a prescribed period, he reinvests an amount equal to or greater than the amount of proceeds in property “similar or related in service or use.” I.R.C. § 1033(a)(2) (2006). The goal is to prevent gain recognition at an inopportune time to the extent the taxpayer does not cash out. Gain not recognized is reflected in a lower basis in the replacement property. I.R.C. § 1033(b)(2).

²⁵⁷ Rev. Rul. 56-518, 1956-2 C.B. 25. Even if recoveries above basis were to be taxed, the Service later effectively permitted affected taxpayers to use the open transaction method to report gain and to treat interest payments as recovery of basis as well: “Whether or not the receipt of an award payment is designated as a recovery of principal or of interest, no part of the payment is taxable gain until the taxpayer’s basis is recovered.” I.R.S. Priv. Ltr. Rul. 83-18-017 (Jan. 28, 1983).

²⁵⁸ See Rev. Rul. 58-370, 1958-2 C.B. 14.

²⁵⁹ Rev. Rul. 69-212, 1969-1 C.B. 34.

²⁶⁰ The first ruling was issued under regulations interpreting the 1939 Code, when the definition of “gross income” had a different section number. Regulations under the 1954 Code had yet to be issued.

“governmental social benefit programs for the promotion of the general welfare” as income.”²⁶¹ Finally, none seemed to depend on administrative difficulties—some receipts of value, while technically income, cannot be policed by the Service in an economically reasonable way²⁶²—rather than principle.²⁶³

These rulings were still on the books when *Murphy I* was decided, and they were obviously embarrassing to the Service given its litigation posture.²⁶⁴ Shortly before the *Murphy II* decision was handed down, the Service withdrew the rulings, supposedly as part of its

continuing . . . program of reviewing guidance . . . to identify items that are obsolete because (1) the applicable statutory provisions have been changed or repealed; (2) the matter is specifically covered by statute, regulations, or subsequent published position; or (3) the facts on which the position is based no longer occur or are not sufficiently described

²⁶¹ Rev. Rul. 2009-19, 2009-28 I.R.B. 111, 111 (holding that pay-for-performance-success payments made to benefit homeowners under the Home Affordable Modification Program are not income); see also Rev. Rul. 98-19, 1998-1 C.B. 840 (ruling that relocation payments made under the Housing and Community Development Act of 1974 to individuals moving from a flood-damaged residence to another residence are not includable in the individual's gross income); Rev. Rul. 74-205, 1974-1 C.B. 21 (ruling that replacement housing payments made for the purpose of aiding individuals and families displaced from their homes, businesses, or farms are not taxable as gross income); Wood, *False Imprisonment*, *supra* note 47, at 287; Robert W. Wood & Richard C. Morris, *The General Welfare Exception to Gross Income*, 109 TAX NOTES 203 (2005). For the exception to apply, the Service generally requires that payments be made from a governmental welfare fund, be based on need, and not be compensation for services. See Wood, *False Imprisonment*, *supra* note 47, at 287; I.R.S. Tech. Adv. Mem. 2000-21-036 (Feb. 15, 2000), reprinted in *Adoption Assistance Payments Excludable*, TAX NOTES TODAY, May 30, 2000, 2000 TNT 104-74 (LEXIS) (concluding that adoption assistance payments are not includable in gross income).

²⁶² If the Service averts its eyes, then, as a practical matter, a receipt of value is not income. For example, after a millisecond's worth of effort to the contrary, the Service decided not to treat receipt and retention of unsolicited samples as income, even though such items are clearly “accessions to wealth” and would not be treated as “gifts” under section 102. See Rev. Rul. 70-498, 1970-2 C.B. 6 (holding that a reviewer who donated unsolicited books to charity must include value in income if he claims a charitable deduction), *superseding* Rev. Rul. 70-330, 1970-1 C.B. 14 (holding that retention of unsolicited books was enough for inclusion). The Service had “apparently made an administrative decision to be concerned with the taxation of unsolicited samples only when failure to tax those samples would provide taxpayers with double tax benefits.” *Haverly v. United States*, 513 F.2d 224, 227 (7th Cir. 1975).

²⁶³ That might be said about the general welfare exception as well. Taxing welfare benefits is doable, although the Service would be criticized if it acted unilaterally. Congress understands what the practice has been, has not tried to change that practice, and, if it approves, has no reason to do anything.

²⁶⁴ Lewis J. Fernandez, Associate Chief Counsel, Income Tax & Accounting, Internal Revenue Serv., Remarks Before the Committee on Tax Accounting, American Bar Association Section of Taxation (Oct. 20, 2006) (calling attention to the rulings, noting how embarrassing they were, and stating that the Service had alerted the Solicitor General to their existence).

to permit clear application of the current statute and regulations.²⁶⁵

The Service made no claim that statutory changes required this decision. It could not reasonably have done so. Indeed, it did not mention section 104(a)(2) in this connection, and it was clear in context that the silence was not inadvertent.²⁶⁶ The official reason for withdrawal of the old rulings must have been that “the facts on which the position[s] [are] based no longer occur,” as if withdrawal were part of a routine housekeeping process.²⁶⁷ The timing of the revocation was obviously dictated by *Murphy*, however, and the revocation should not have hidden a basic fact: *the relevant law had not changed*.

I have heard it said that those rulings were historical artifacts, which had lacked any significance for decades. But the Service itself issued a private letter ruling in 1998 that relied entirely on the published rulings.²⁶⁸ The significance of those rulings extended far beyond the factual situations they described, and beyond 1996, when section 104(a)(2) was amended.²⁶⁹

The private ruling concluded that one-time payments made from a fund established by an unidentified country and funded by a national bank, private banks, and other companies would not be taxable to recipients who met certain criteria²⁷⁰: in general, they had to have lived under an oppressive regime; had to be citizens or permanent residents of the United States; and had to declare themselves to be in need.²⁷¹ If the criteria were satisfied, a payment was “in the nature of reimbursement for the deprivation of personal or civil rights as described in the revenue rulings. Accordingly, the payment is not includible in your [gross] income.”²⁷²

The 1998 private ruling was not aberrational either. The Service had issued other letter rulings to the same effect—one in 1996 to a

²⁶⁵ Rev. Rul. 2007-14, 2007-1 C.B. 747. The Service also declared Revenue Ruling 71-477 obsolete. See *supra* note 255. It had become irrelevant if the other rulings were obsolete.

²⁶⁶ After declaring the various rulings obsolete, with no mention of section 104(a)(2), the Service explicitly relied on section 104(a)(2) in withdrawing its acquiescence in two Board of Tax Appeals decisions. See *infra* text accompanying note 279.

²⁶⁷ Rev. Rul. 2007-14, 2007-1 C.B. 747.

²⁶⁸ See I.R.S. Priv. Ltr. Rul. 1999-06-004 (Oct. 27, 1998).

²⁶⁹ The level of review for private rulings is not as stringent as for published rulings, and private rulings are not supposed to be treated as authority for many purposes. My point is only that reports of the demise of the published rulings were greatly exaggerated.

²⁷⁰ Identifying information is redacted when private rulings are made available under the Freedom of Information Act.

²⁷¹ See I.R.S. Priv. Ltr. Rul. 1999-06-004 (Oct. 27, 1998).

²⁷² *Id.* Given the need requirement, this situation might have fit under the general-welfare doctrine, but the conclusion was based on the published rulings.

recipient of payments from the Dutch government associated with “persecution and physical and psychological injuries” during the Nazi occupation of the Netherlands;²⁷³ one in 1993 to an Aleut who received distributions from a trust created to reimburse U.S. citizens wrongly relocated to internment camps during the Second World War;²⁷⁴ and one in 1992 to a former citizen of Holland who received payments from the Dutch government under a special pension act to compensate for injuries incurred in resisting the Nazi occupation.²⁷⁵ All concluded that taxpayers had no income because they had merely been “reimburse[d] for the deprivation of civil or personal rights.”²⁷⁶

None of this is ancient history. It was not so long ago that the Internal Revenue Service itself assumed that not all recoveries of cash, even when no basis offset was involved, were automatically taxable.²⁷⁷ If those recoveries were not income in the 1950s, 1960s, and 1990s, with *Glenshaw Glass* already on the books, nothing had happened statutorily in the meantime to change the result. Conceptions of income might have changed in the academy, but those changed conceptions were not reflected in any congressional enactment or judicial reinterpretation.²⁷⁸

ii. Revocation of Acquiescences in Old Cases

When the Service declared the rulings discussed above obsolete, it also withdrew embarrassing acquiescences to two Board of Tax Appeals decisions involving nonphysical injury recoveries. The Service gave section 104(a)(2) as the reason for the withdrawal:

[I]n light of the amendments to § 104(a)(2)[,] certain acquiescences to decisions are obsolete. These amendments

²⁷³ I.R.S. Priv. Ltr. Rul. 96-29-017 (Apr. 22, 1996) (concluding that the payments “are in the nature of reimbursement for the deprivation of civil or personal rights and do not constitute income”).

²⁷⁴ I.R.S. Priv. Ltr. Rul. 94-06-011 (Nov. 9, 1993) (holding that the distributions were “in the nature of reimbursement for the deprivation of . . . civil or personal rights” and not includable in gross income).

²⁷⁵ I.R.S. Priv. Ltr. Rul. 92-23-046 (Mar. 10, 1992) (holding that the payments “are in the nature of reimbursement for the deprivation of civil or personal rights” and are therefore not taxable).

²⁷⁶ See *supra* notes 273–75.

²⁷⁷ See I.R.S. Priv. Ltr. Rul. 2001-27-040 (Apr. 10, 2001) (citing Revenue Ruling 56-518, 1956-2 C.B. 25, as still valid on an issue ultimately governed by treaty language). It was thus not correct to say in 2005 that “there is no doctrinal support for the notion that cash received as the result of an involuntary occurrence is excludable apart from statutory exclusions and deferral provisions.” Dodge, *Jensen’s Missiles*, *supra* note 16, at 132.

²⁷⁸ For example, Professor Caron described *Murphy I* as undoing a half century of tax jurisprudence, see *supra* text accompanying note 14, but authority still supported a restrictive conception of income in 2007.

make clear that Congress intended “that the exclusion from gross income [under § 104(a)(2)] only applies to damages received on account of a personal physical injury or physical sickness,” and thus damages received on account of personal nonphysical injuries or nonphysical sickness generally would be required to be included in gross income.²⁷⁹

Note the “generally,” however, a word to which I will return.

In *Hawkins v. Commissioner*,²⁸⁰ decided in 1927—cited in *Clark*²⁸¹ and *Murphy I*²⁸²—the Board had concluded that a recovery for libel, when the compensation was only for damage to personal reputation, was not income absent express congressional indication to the contrary.²⁸³ Twenty-eight years before *Glenshaw Glass*, the Board suggested that the implication in cases like *Eisner v. Macomber*²⁸⁴—that income can arise only from capital or labor—was not necessarily right.²⁸⁵ No matter. This recovery was “wholly personal and nonpecuniary,”²⁸⁶ and “[s]uch compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury.”²⁸⁷ The recovery would have been taxable if Congress had made “express provision”²⁸⁸ to that effect—this was not a constitutional case—but Congress had not done so.

In *McDonald v. Commissioner*,²⁸⁹ decided in 1928 and also cited in *Clark*,²⁹⁰ the Board had come to the same result for a recovery of damages for breach of a promise to marry—damages that could have related, depending on the jury’s determination, to “mortification and

²⁷⁹ Rev. Rul. 2007-14, 2007-1 C.B. 747 (alteration in original) (citing H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.), reprinted in 1996-3 C.B. 741, 1041).

²⁸⁰ 6 B.T.A. 1023 (1927), *acq.*, 7-1 C.B. 1, 14 (1928).

²⁸¹ 40 B.T.A. 333, 335 (1939), *acq.*, 1957-1 C.B. 4; *see also supra* text accompanying note 209.

²⁸² 460 F.3d 79, 91 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

²⁸³ *See Hawkins*, 6 B.T.A. at 1024–25.

²⁸⁴ 252 U.S. 189 (1920).

²⁸⁵ The *Hawkins* court noted:

[I]t is conceivable that since the income tax is primarily an application of the idea of measuring taxes by financial ability to pay, as indicated by the net accretions to one’s economic wealth during the year, there may be cases in which taxable income will be judicially found although outside the precise scope of the description already given.

Hawkins, 6 B.T.A. at 1024.

²⁸⁶ *Id.* at 1024–25.

²⁸⁷ *Id.* at 1025.

²⁸⁸ *Id.*

²⁸⁹ 9 B.T.A. 1340 (1928), *acq.*, 7-2 C.B. 1, 26 (1928).

²⁹⁰ 40 B.T.A. 333, 335 (1939), *acq.*, 1957-1 C.B. 4.

pain or distress of mind . . . ; loss of social standing . . . ; injury to future prospects of marriage . . . ”;²⁹¹ and so on.²⁹² The result in *McDonald* was dependent on the result in *Hawkins*,²⁹³ and if the Service would no longer follow *Hawkins*, it would also no longer follow *McDonald*.

In support of withdrawing the acquiescences, the Service cited to the conference committee report on the 1996 legislation, and a comment on the legislative history is in order. As I noted earlier, the conference committee report used the heading “[i]nclude in income damage recoveries for nonphysical injuries” as if receipt of compensation for a nonphysical injury were automatically taxable.²⁹⁴ But the text of the report simply says that, as a result of the statutory change, only a recovery for a physical injury is covered by section 104(a)(2).²⁹⁵ That is true, but not very interesting. The headings overstate the conclusion of the text.

And the Service’s bottom-line conclusion contains that intriguing “generally”: “damages received on account of personal nonphysical injuries or nonphysical sickness *generally* would be required to be included in gross income.”²⁹⁶ Although this suggests that the proposition is not always true, one searches in vain for guidance about the exceptional cases.

Maybe the “generally” had something to do with recoveries that, because of transition rules, are not governed by the statutory change, or to the possibility that a nonphysical injury might be closely enough tied to a physical injury to implicate section 104(a)(2).²⁹⁷ If the drafters had these situations in mind, however, the point could have been made straightforwardly.

Another possibility is that the “generally” was inadvertent. Lawyers drop “generallys,” “usuallys,” and “ordinarilys” into everyday discourse. (If you do not know whether an exception exists, cover yourself: “The sun generally rises in the east.”)

²⁹¹ *McDonald*, 9 B.T.A. at 1341.

²⁹² I would have thought that a jury might include something to reimburse an aggrieved party for nondeductible amounts spent in anticipation of marriage. See *infra* Part V.B.3.

²⁹³ See *McDonald*, 9 B.T.A. at 1342.

²⁹⁴ See H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.), *reprinted in* 1996-3 C.B. 741, 1041; see also *supra* notes 188–91 and accompanying text.

²⁹⁵ See H.R. REP. NO. 104-737, at 301.

²⁹⁶ Rev. Rul. 2007-14, 2007-1 C.B. 747 (emphasis added) (citing H.R. REP. NO. 104-737).

²⁹⁷ See *supra* Part V.B.1. The report discussed two situations: If emotional distress arises as part of a personal physical injury, the portion of the recovery attributable to the distress would continue to be excludable, while that would not necessarily be true with an emotional-distress component of a recovery for a nonphysical injury. See H.R. REP. NO. 104-737, at 301; see also *supra* note 226.

Habituated to “generallys,” lawyers can forget that some propositions are always true, and that a “generally” can be misleading.

But this “generally” appeared in a written document subject to substantial review; it must have been intentional. Did Service personnel come to realize that, even as they were reviewing old authority to take account of amended section 104(a)(2), a blanket requirement that a nonphysical personal injury recovery must be taxed in its entirety would be wrong?

3. *How Common Is Recovery of Basis?*

Whatever commentators think about the rulings discussed in the preceding section, I know of no one who thinks the amendments to section 104(a)(2) were intended to make taxable a recovery of basis arising from a nonphysical personal injury—at least not if the compensation comes from the tortfeasor or an insurance company.²⁹⁸

If by basis recovery we mean recovery of previously nondeductible outlays, as in *Clark*, the scope of the basis-recovery doctrine is potentially quite broad. I am not sure how damages are determined in an alienation-of-affections or breach-of-promise-to-marry lawsuit, and I hope never to find out, but I can imagine a jury or parties negotiating a settlement trying to figure how much a poor spouse had spent trying to save a failing marriage, or how much a spurned fiancée had spent gearing up for a wedding—dollars that were not deductible when paid. Might the analysis of the tax effects of a recovery in such a situation be analogous (or more than analogous) to a basis-recovery situation? If not, why not?²⁹⁹ If the goal was to make someone financially whole by making the responsible party compensate for out-of-pocket costs, and the compensation amount was determined on the assumption that the award would not be taxable, exclusion of the recovery would be appropriate.³⁰⁰ That is the *Clark* case, in different garb.

Of course, a taxpayer has the obligation to demonstrate basis or its equivalent if he is claiming an offset to an amount realized. But even if we might question the amount of basis claimed in a particular case,

²⁹⁸ If the victim's employer, say, compensates the victim for a nondeductible loss unrelated to employment, there would be income. We would not be talking about recovery of basis in that case.

²⁹⁹ To the extent of punitives, the recovery would be taxable. See Rev. Rul. 74-77, 1974-1 C.B. 33 (positing that “[n]one of the amounts received constituted exemplary or punitive damages”).

³⁰⁰ If a jury were instructed to assume the award would be taxable and it grossed up the award, inclusion of the recovery would be the theoretically right result. Absent jury instructions on the matter, however, the typical juror would have no idea that an award might be taxed.

surely there would be no doubt in an alienation-of-affections or breach-of-promise-to-marry situation that *some* basis existed—some nondeductible, out-of-pocket costs were being restored—and that at least part of the recovery might be excludable.

The common argument against an analysis of that sort for many tort recoveries is that we are talking about “human capital”—the *Murphy* panel made specific reference to the concept³⁰¹—and no one, it is said, can have basis in human capital. Professor Dodge states that

[s]ome might argue that a person has a basis equal to the sum of human-capital expenditures, which might include such items as outlays for food, education, preventive health care, vitamins, and minerals. Unfortunately, no one keeps track of these outlays, nor would it be feasible to do so. Most (or all) of the foregoing are nondeductible personal expenses and not capital expenditures.³⁰²

Propositions like that are regularly and forcefully advanced, as if there can be no doubt that human capital has a zero basis.³⁰³ In *Murphy I*, the government argued that, “[b]ecause people do not pay cash or its equivalent to acquire their well-being [*sez who?*], they have no basis in it for purposes of measuring a gain (or loss) upon the realization of compensatory damages.”³⁰⁴ And in *Murphy II*, the government was more categorical: “The Code does not allow individuals to claim a basis in their human capital.”³⁰⁵

I do not understand why that is so. Professor Geier has fleshed out the “no basis in human capital” argument as it might apply to

³⁰¹ See *Murphy II*, 493 F.3d 170, 177–78 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008); *Murphy I*, 460 F.3d 79, 85–87 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

³⁰² Dodge, *Taxes and Torts*, *supra* note 196, at 152 (footnote omitted).

³⁰³ See, e.g., 1 BITTKER & LOKKEN, *supra* note 172, ¶ 5.6, at 5-40 (arguing for taxability of various recoveries, unless Congress provides otherwise, “[s]ince defamation or alienation of affections does not entail the loss of something for which the taxpayer paid cold cash”); Geier, *supra* note 76, at 582 (“[A] tax-free return of capital necessarily entails basis—previously taxed dollars—which no one can create in his own body or mind. Because Murphy had no basis in her human capital, the entirety of the cash she received was gross income within the meaning of the residual clause in section 61.”).

³⁰⁴ *Murphy I*, 460 F.3d at 87 (first alteration in original) (internal quotation marks omitted).

³⁰⁵ *Murphy II*, 493 F.3d at 178 (internal quotation marks omitted). When I see a statement about what “the Code” does not allow, I expect to see a statutory citation. But the citation in *Murphy II* was to a Ninth Circuit decision predating the amendment of section 104(a)(2). See *id.* (citing *Roemer v. Comm’r*, 716 F.2d 693, 696 n.2 (9th Cir. 1983)). The *Murphy II* court pulled the following quotation from *Roemer*: “Since there is no tax basis in a person’s health and other personal interests, money received as compensation for an injury to those interests might be considered a realized accession to wealth.” *Id.* (quoting *Roemer*, 716 F.2d at 696 n.2). The court characterized the quoted language as “dictum.” *Id.*

Murphy, but, as I will explain, it is not convincing:

[T]here are no previously taxed dollars to recover tax-free here. [Murphy] made no nondeductible capital expenditure that created her bodily integrity, emotional well-being, and professional reputation. Any outlays that she incurred to keep her body and mind in good operating condition are current expenses (current net wealth decreases, as opposed to capital expenditures). Most of those expenses would be “personal” [and] nondeductible for that reason. Except in the case of a personal expense that is refunded, nondeductible expenses do not generally create basis, or else they could provide a delayed tax benefit that is inconsistent with the nondeductibility of the personal expense.³⁰⁶

We should have a skeptical attitude about basis claimed in human capital,³⁰⁷ but Professors Dodge and Geier go too far. I do not know how we can be sure that Murphy made no nondeductible (but measurable) capital expenditures to create the human capital that was converted. Could there not have been some nondeductible education expenses, say—almost certainly “capital” in nature—that contributed to her professional reputation, a reputation that was determined to have been injured? Had the right questions been asked, perhaps Murphy could have substantiated some costs. And even if this would not have worked for Murphy, this would be a relevant inquiry in other cases where conversion of human capital is claimed.

In fact, notwithstanding Professor Dodge’s certainty to the contrary, people do keep track of expenditures that contribute to human capital—not the amount spent on pencils in the first grade, of course, but the costs of college are not difficult to track.³⁰⁸ That sort of information is not being presented in tax litigation involving nonphysical injuries because almost everyone is assuming the full

³⁰⁶ Geier, *supra* note 76, at 580.

³⁰⁷ We should therefore not assume that the amount of a personal injury recovery equals basis. Professor Dodge has called recovery-equals-basis a “sentimentalist” position:

On the merits, human capital should not be treated as a conventional asset with basis. Not only is it impossible to keep track of costs, but there are also conceptual problems. By what coherent principle would one distinguish between the capital expenditure and the expense portions of food, education, etc.? Is human capital used in business to earn wages, or is it held for personal consumption to enjoy life?

Dodge, *Taxes and Torts*, *supra* note 196, at 153.

³⁰⁸ There can be other conceptual problems: if Mom and Dad paid for the educational expenses of their injured child, should the child have “basis”? I would argue yes, that for these purposes the transfer was a gift from parents to child, but I can understand that others would disagree.

recovery is taxable. If your lawyer tells you that (or tells you nothing at all), or if a court says it does not matter what basis you might have, why provide information?

But suppose a damages recovery by its terms reflects an effort on the part of the judge, jury, or negotiating parties to determine the amount of nondeductible dollars that had been spent developing converted human capital.³⁰⁹ To say that basis is difficult to determine is not to say that no basis exists. And there is no reason to ignore all expenditures because some are difficult to track.³¹⁰ Remember that we are talking about *converted* capital: *Murphy* proceeded on the assumption that Ms. Murphy had really lost something, and she was being compensated for a loss, not being awarded a windfall.³¹¹

I am also unconvinced that the distinction between capital expenditures and current expenses is relevant. In a business setting, we distinguish between current expenses, which ought to be deductible and therefore not create basis, and capital expenditures, which are generally not currently deductible but will create basis if there is an asset to which they can be attributed. But in the personal setting, neither current expenses nor capital expenditures are usually going to be deductible. Whether current or capital in nature, the costs are after-tax costs.

If there is a recovery of previously taxed dollars—which is what we are talking about with basis—why should we care whether the nondeductible expenditures were ordinary or capital in nature? If the connection between an expenditure and a later recovery can be shown—not always impossible—the key question should be whether that expenditure was deductible or not.

I have always understood *Clark* as a basis-recovery case, as have others, even though no capital expenditure was involved: the tax

³⁰⁹ If the expenditures were deductible, then no basis would have been created. No expenditure should be both deductible and reflected in basis—unless Congress provides for double-counting to provide an incentive for particular activity.

³¹⁰ Even though a taxpayer has the obligation to demonstrate basis that would reduce gain on disposition of an asset—just as he must demonstrate entitlement to exclude something from income or to take a deduction—the Service will ordinarily not require him to treat the basis as zero in the absence of records. For example, if you sell an item that has been passed from generation to generation in your family, and you do not have records necessary to apply sections 1014 and 1015, the Service will generally accept a reasonable figure. See I.R.C. § 1015(a) (2006) (setting out rules for difficult situations). Why should the same rule of thumb not apply with conversion of human capital?

³¹¹ Wages are different, as I discuss later. See *infra* Part V.I.E. The arrangement is generally voluntary. The performance of services does not necessarily use up human capital, and the compensation does not purport to be for capital. In *Murphy*, the assumption was that human capital had been converted. See *Murphy II*, 493 F.3d 170, 185 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

payment was for the current year's tax liability.³¹² But if there is reluctance to use the term "basis" for a nondeductible current expenditure, then let us find a new word. Whatever term is used, the recovery of previously taxed dollars, when the recovery is funded by the person who caused the loss (or by an insurer), should be tax-free.

Professor Geier is worried about a deferred benefit from an otherwise nondeductible, noncapital, personal expenditure—a benefit inconsistent with the idea that personal expenditures are not deductible.³¹³ That is a concern in many contexts, but why here?³¹⁴ Using a previously nondeductible cost to offset a recovery is a benefit, certainly if the baseline for comparison is that a recovery ought to be taxable. But, as was true in *Clark*, the benefit is justified—offsetting a nondeductible loss or expenditure with an untaxed recovery.³¹⁵ Indeed, it is the point of this exercise—as in *Clark*—to provide an offset.

Suppose, for example, you pay your gardener \$10,000 to plant annuals around your house—a nondeductible current expense. A well-heeled thug trashes the yard, and you successfully sue the guy to recover the \$10,000. Can it be true that the full \$10,000 is taxable because you have no basis associated with your noncapital expenditure, and no statutory provision provides for an exclusion?³¹⁶ Assuming the connection between the loss and the recovery can be demonstrated, *of course the recovery should be tax-free.*³¹⁷

Is this example too easy and therefore unrepresentative of the more typical case, where the relationship between a recovery and previously nondeductible expenditures will not be obvious? Maybe so, but the difficulties of demonstrating basis in many cases should

³¹² See *supra* Part V.B.1.

³¹³ See *supra* text accompanying note 306.

³¹⁴ Maybe what happens with recoveries for personal injuries cannot be governed by "generally" applicable rules. The events are by their nature unusual.

³¹⁵ Professor Geier says that treating a nondeductible current expenditure as creating basis might be appropriate in determining the effect of a *refund*. See *supra* text accompanying note 306. The principle should not be so limited. Indeed, *Clark* has been characterized as a case where the result should have been the same as if Uncle Sam had refunded the extra tax. See *supra* note 213.

³¹⁶ This is not a "personal" injury, but the example still makes my point. Although there is physical damage, and the injury might be a tort, the injury is not to the *person*, and section 104(a)(2) should therefore be irrelevant. The term "personal" in the statute should have reference both to "tort or tort type rights," as set out in the regulations, and damage to the person.

³¹⁷ Make the expenditure capital. The gardener builds a greenhouse for you, cost \$10,000. Nothing associated with the creation of "horticultural capital" is deductible, however, because no Code section provides authority to deduct this personal expenditure. The thug trashes the greenhouse, and you recover \$10,000. Income? No. The result is the same as in the first variation. Tax-free dollars should compensate for the loss of already taxed dollars, whether the initial expenditure was capital or not.

not affect the analysis where basis can in fact be demonstrated.

Perhaps the conceptual problem in the personal-injury context is exacerbated by the use of the term “human capital,” which covers a mishmash of quite different attributes.³¹⁸ For many commentators, the term is used as a shorthand way of concluding that a recovery should be taxable. Human capital? No basis. I question that position.

To be sure, with many of the expenditures that are often described as enhancing human capital, we cannot expect people to have kept records or otherwise to be able to reconstruct the amounts involved. Furthermore, there are relatively few situations in which the idea of a “recovery” of the typical expenditure for human capital would make sense. We do not want to let expenditures made by Mom and Dad for one’s baby food turn into a basis offset forty years later.

For some expenditures, however, keeping track is not a problem; expenses for education are obviously different in that regard from expenditures for “vitamins” and “minerals.”³¹⁹ And viewing the benefit of a nondeductible expenditure as having been lost is not out of the realm of possibility. These situations might be unusual (and might not include *Murphy*). But it makes no sense to have a categorical no-basis rule. The question to ask is whether a taxpayer received amounts from the person who caused a personal injury that compensated for previously nondeductible outlays. If so, and if the taxpayer can demonstrate the amount with an acceptable level of precision, recovery of basis is inevitably implicated.

Suppose a would-be professional pianist pays tuition at a conservatory building up “human capital.” He cannot deduct the expenditures when incurred because he is not yet carrying on a trade or business.³²⁰ At best, the expenditures are “start-up expenditures,” a form of capital expenditure for which there might ultimately be an effect under the Code, but for which there is none currently.³²¹

Now suppose we are in a world without section 104(a)(2), and the

³¹⁸ Professor Dodge defines recoveries for injuries to “human capital” as encompassing “damages for lost wage-earning capacity, including recoveries for lost past wages,” Dodge, *Taxes and Torts*, *supra* note 196, at 147, and a recovery of that sort should be taxable (unless Congress provides otherwise). But the definition used by others is broader, and, in *Murphy*, the panel had concluded that no lost-earning potential was involved.

³¹⁹ But see *supra* text accompanying note 302.

³²⁰ The costs are therefore not ordinary and necessary business expenses. See I.R.C. § 162 (2006).

³²¹ If the pianist later becomes a professional, he would be able to amortize the previously nondeductible costs of creating a business over a fifteen-year period if he can demonstrate the expenditures would have been deductible for someone already in the business. See I.R.C. § 195 (2006). The costs of conservatory instruction should be deductible by a professional pianist. See Treas. Reg. § 1.162-5 (as amended in 1967) (announcing that certain education expenses are deductible as business expenses).

musician is injured in an accident and loses a finger on his left hand. He sues the tortfeasor and recovers an amount that can reasonably be considered to include compensation for the tuition that, because of the injury, cannot lead to its desired result. Would that portion of the recovery be taxable in a world without section 104(a)(2)? Surely we have the equivalent of basis here.³²²

Change the facts. Make the injury emotional distress so severe that it becomes impossible to carry out the career for which the tuition was spent. Section 104(a)(2) is inapplicable by its terms, but assume the pianist can show a connection between injury and lost career. (Yes, there are emotionally disturbed pianists, but let us assume that mental distress might make a concert career impossible.) Any recovery ought to be offset by the amount of nondeductible tuition. Maybe other offsets can be found as well, but at least the wasted tuition should be an offset.

An unlikely set of facts? Of course. Impossible? Not at all. And here is another example, based on a real occurrence, of a basis offset in a nonphysical personal injury situation. A couple, nervous about messy personal problems, paid a law firm to keep their names out of the newspapers. Although it did its best, the firm was unsuccessful, and some embarrassing information became public.³²³ The couple sued the privacy-invader and recovered. The couple should not be taxed on any portion of the recovery that represents a recoupment of the amount paid the law firm. That is a recovery of basis, with no difficulty in measuring amount.

It might be that Ms. Murphy could have demonstrated no basis. The amount of her award was based on "awards made in other cases involving comparable degrees of injury,"³²⁴ rather than a determination of actual expenditures made, and Murphy asked for more compensation based on severity of the injury, not the amount of out-of-pocket costs.³²⁵ But we do not know what Murphy would have been able to demonstrate had the right questions been asked. And there is no categorical reason why a recovery in such circumstances should be taxable in the absence of a specific exclusion to that effect.

³²² I am assuming the pianist would not be entitled to take a deduction when he is forced to abandon creation of a business. In any event, the amount of any abandonment loss would be limited to basis.

³²³ I cannot reveal further details without invading privacy.

³²⁴ *Leveille v. N.Y. Air Nat'l Guard*, No. 98-079, 1999 DOL Ad. Rev. Bd. LEXIS 105, at *7 (Dep't of Labor Admin. Rev. Bd. Oct. 25, 1999).

³²⁵ *Id.* at *7-8.

4. Gotcher: “Gross Income” Is Not All-Encompassing

One might think commentators arguing for a broad conception of income, which would pick up the recovery in *Murphy*, routinely take the position that any receipt of value, outside the recovery-of-basis context, is automatically taxable, unless Congress provides explicitly to the contrary,³²⁶ or unless the Internal Revenue Service decides to let certain accessions to wealth go.³²⁷ One might also think that the income-tax provisions of the Internal Revenue Code should be interpreted on the assumption that, as a multitude of judicial opinions have said, Congress meant to exercise its full taxing power.³²⁸

In fact there is widespread understanding that certain benefits are not taxable, even though the Constitution would not require that result, no Code provision justifies an exclusion, and enforcement issues appear manageable.³²⁹

Begin a conversation with a tax professor about in-kind benefits that arguably constitute a form of “forced” consumption,³³⁰ and the prof is likely to respond: “Gotcher!” a reference to *United States v. Gotcher*.³³¹ The Fifth Circuit in 1968 held that an expense-paid trip to Germany, paid partly by Mr. Gotcher’s employer, a Volkswagen dealership, and partly by the larger Volkswagen organization, was not taxable to Gotcher because the trip “primarily benefit[ed] the party paying for the trip,”³³² even though it had elements of pleasure. Volkswagen was trying to convince U.S. dealers and investors about the merits of its organization and products.³³³

While in Germany, Mr. Gotcher was forced to keep his nose to the grindstone, visiting one VW facility after another rather than going to Bayreuth: “[T]he personal benefit to Gotcher was clearly subordinate to the concrete benefits to VW.”³³⁴ (The benefit provided

³²⁶ Congress has done that, for example, with gifts, municipal bond interest, and various employer-provided fringe benefits. See I.R.C. §§ 102, 115, 132 (2006).

³²⁷ See *supra* note 262.

³²⁸ See, e.g., *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955) (“This Court has frequently stated that this language [the definition of “gross income” in the 1939 Code] was used by Congress to exert in this field ‘the full measure of its taxing power.’” (quoting *Helvering v. Clifford*, 309 U.S. 331, 334 (1940)) (citing *Helvering v. Midland Mut. Life Ins. Co.*, 300 U.S. 216, 223 (1937); *Douglas v. Willcuts*, 296 U.S. 1, 9 (1935); *Irwin v. Gavit*, 268 U.S. 161, 166 (1925))).

³²⁹ I say “non-cash” benefits, although many of these cases involve cash reimbursements.

³³⁰ I have put “forced” in quotation marks because, although the adjective is often used, the amount of force involved in these cases is typically minimal.

³³¹ 401 F.2d 118 (5th Cir. 1968).

³³² *Id.* at 122.

³³³ See *id.* at 121.

³³⁴ *Id.* at 123.

to Mrs. Gotcher was taxable, however. Her trip was a vacation.³³⁵) For there to be income, concluded the Fifth Circuit, “[t]here must be an economic gain, and this gain must primarily benefit the taxpayer personally.”³³⁶

I am not sure how enthusiastic the Internal Revenue Service is about the *Gotcher* doctrine—not very, I suspect³³⁷—but *Gotcher* has been interpreted by academics to support not taxing in-kind benefits in many different circumstances. For example, should a law student have income associated with callback interview trips paid by law firms? Because the student is not yet engaged in a trade or business, the expenditures would not have been deductible if she had paid them herself.³³⁸ As a result of the reimbursements, the student receives a clear economic benefit—certainly if she winds up employed—from someone else’s absorbing her nondeductible costs.³³⁹ I am not even sure it is appropriate to say, under the circumstances, that “the personal benefit to [the law student would be] clearly subordinate to the concrete benefits to [the law firm].” But the understanding is that there is no income in such a case.³⁴⁰

If we were drafting a statute from scratch, that might be the position we would want to adopt, but where in the Code does that principle come from? I have been assured by *Gotcher* fans that they are not making a constitutional argument: nothing in the Constitution

³³⁵ *Id.* at 124. With regard to Mr. Gotcher, the facts could be distinguished from *Rudolph v. United States*, 370 U.S. 269 (1962), where a trip to New York provided by an insurance company to its most productive employees and their spouses was clearly nothing but a frolic. The trip benefited the employees and not the employer, except in the sense that paying compensation has benefits to the employer. *Id.* at 277.

³³⁶ *Gotcher*, 401 F.2d at 121.

³³⁷ In the only published ruling in which the Service has cited *Gotcher*, Rev. Rul. 81-277, 1981-2 C.B. 14, it explained that “[i]nherent in section 61 of the Code is the concept of economic gain. For a taxpayer to have income under section 61, there must be an economic gain that benefits the taxpayer personally.” *Id.* at 15. That unexceptionable proposition had little to do with *Gotcher*, the point of which was that no income would be recognized even with a personal benefit, if the primary benefit was to the payor. *Gotcher*, 401 F.2d at 122. In private rulings citing *Gotcher*, the Service has simply restated language used in the published ruling, see, e.g., I.R.S. Priv. Ltr. Rul. 86-04-065 (Oct. 30, 1985) (concluding that a benefit was taxable when an employee was primarily benefitted); I.R.S. Priv. Ltr. Rul. 85-47-003 (Aug. 27, 1985); or otherwise distinguished *Gotcher*’s situation, see, e.g., I.R.S. Priv. Ltr. Rul. 79-02-018 (Sept. 29, 1978).

³³⁸ See I.R.C. § 162(a) (2006) (permitting deduction for ordinary and necessary expenses of carrying on a trade or business); cf. I.R.C. § 195 (2006) (treating start-up expenditures as not deductible, but then permitting amortization in some circumstances). No gift is involved in such circumstances.

³³⁹ In one respect, this is like *Clark*: the compensation replaces nondeductible dollars and therefore has a basis-recovery aspect to it.

³⁴⁰ The Service agreed, in a pre-*Gotcher* ruling. See Rev. Rul. 63-77, 1963-1 C.B. 177 (treating reimbursed interview expenses as not includable in gross income); see also Rev. Rul. 80-99, 1980-1 C.B. 10 (holding that reimbursement of expenses in a non-employment context is not gross income).

would preclude Congress from taxing such “forced” consumption if it wished. And nothing in the language of section 61, which reaches “income from whatever source derived,” precludes treating forced consumption as gross income to the extent the recipient receives a benefit.

Administrative convenience inevitably plays a role in determining what, as a matter of practice, will be included in the tax base, but convenience is not an argument grounded in statute or theory. And in *Gotcher* itself, the government had assessed the tax deficiency.³⁴¹ No administrative inconvenience was involved there.

So where did the authority not to tax *Gotcher* come from? Professor Geier attributes the doctrine to courts that have been “convinced that Congress would not have intended taxation of the receipt. That most often occurs when consumption received in kind is not compensation, a dividend, or any other type of specifically listed item of gross income.”³⁴² The Fifth Circuit stated that “it has been generally held that exclusions from gross income are not limited to the enumerated exclusions” in the Code.³⁴³ That statement by itself supports my thesis—that long-time understandings may trump a modern economist’s conception of what ought to be treated as income—and perhaps I should just leave it at that.

But the interesting thing about *Gotcher* is that the tax professoriate generally embraces its result even though the Fifth Circuit’s analysis provides no intellectual support. The *only* authority cited for the proposition that “exclusions from gross income are not limited to the enumerated exclusions”³⁴⁴ was the “convenience of the employer” doctrine, developed judicially and administratively before enactment of the Internal Revenue Code of 1954. Under that doctrine, the value of meals or lodging provided by an employer to an employee was not taxed to the employee under certain circumstances—if the benefit was for the “convenience of the employer” rather than the convenience of the employee.³⁴⁵

It is true, as the *Gotcher* court emphasized, that the “convenience of the employer” doctrine developed without Code language to support it, but it is also the case that the 1954 Code included a provision, section 119, codifying (with some modifications) the

³⁴¹ See *Gotcher*, 401 F.2d at 120.

³⁴² Geier, *supra* note 76, at 577.

³⁴³ *Gotcher*, 401 F.2d at 120.

³⁴⁴ *Id.*

³⁴⁵ *Id.* at 120 n.3 (citing I.R.C. § 119 (1964)). Under this striking principle, the full value is excludable, even though the employee would otherwise have had to pay for meals and lodging with after-tax dollars.

judicially and administratively blessed doctrine.³⁴⁶ The existence of section 119, which was on the books when *Gotcher* was decided, is hardly support for the idea that Congress intended to preserve extra-statutory exclusions from gross income when it recodified revenue statutes in 1954. In fact, if I had been on the *Gotcher* panel, I would have inferred the opposite: When a sympathetic case for exclusion presents itself, Congress knows what to do.

In any event, the result in *Gotcher* cannot depend on the language of the Code, and it cannot depend on Congress's unstated intentions in enacting section 61. There must be an "unless" at work here. At bottom, the position supporting *Gotcher* has to be that some economic benefits are just not income—in this case, receipts of value that primarily benefit the transferor, rather than the recipient. That is my point: just because an economic benefit is not explicitly excluded from the tax base does not mean it will be taxed.

Yes, *Gotcher* is different from Ms. Murphy's situation. She received cash,³⁴⁷ and *Gotcher* received in-kind benefits.³⁴⁸ And if we were to require *Gotcher* to recognize income, a discount might be appropriate to reflect that the benefits were inalienable and the trip was partly for business. Although *Gotcher* was not an employee of the larger Volkswagen enterprise,³⁴⁹ what he received was similar to what is today called a working condition fringe (a benefit paid by an employer that, had it been paid by the employee, would have been deductible to the employee).³⁵⁰ Given that *Gotcher's* trip was overwhelmingly business-related, he would have had a plausible argument for deducting most of the cost of the trip had

³⁴⁶ *Id.*; see also I.R.C. § 119 (1954).

³⁴⁷ See *Murphy II*, 493 F.3d 170, 172 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008). Professor Geier writes:

Cash *always* qualifies as residual gross income [i.e., "income from whatever source derived" under section 61] (and thus is includable absent a specific statutory exclusion enacted by Congress to exempt this otherwise includable gross income) unless (1) it has, in effect, been previously taxed to the recipient, that is, is a recovery of basis, (2) it is borrowed money that must be repaid, or (3) it is a government welfare payment or similar government payment.

Geier, *supra* note 76, at 577 (footnote omitted). As the discussion in Part V.B.2 indicated, however, many cash recoveries have been deemed excludable over the years without fitting into any of those three categories.

³⁴⁸ *Gotcher*, 401 F.2d at 119. But Mrs. *Gotcher* also received in-kind benefits, and she had income. *Id.* at 124. And the benefits made it unnecessary for the *Gotchers* to expend the cash themselves.

³⁴⁹ See *id.* at 118–19.

³⁵⁰ Part of the cost was paid for by *Gotcher's* employer, and that part might have been treated as a working condition fringe under today's law. See I.R.C. § 132(a)(3), (d) (2006). Regulations define "employee" broadly. See, e.g., Treas. Reg. § 1.132-1(b)(2) (as amended in 1993).

he paid for it himself.³⁵¹

That is not the way that *Gotcher* has been interpreted, however. Indeed, if *Gotcher* had been interpreted in that way, we would pay no attention to the case today: there is no reason to care about a technical inclusion in income if an offsetting deduction would be available anyway. *Gotcher* has been interpreted very differently: Certain benefits, the cost of which would not be deductible to the recipient, might nevertheless not be treated as gross income. We care about *Gotcher* because it stands for the proposition that not every receipt of a benefit is taxable, and that is so even if the Code includes no specific exclusion to that effect.

C. Analyzing a Recovery for a Personal Injury: The “In Lieu of” Test

How should one analyze a recovery for a nonphysical personal injury with amended section 104(a)(2) on the books? Apply first principles. Ask questions like those raised in the first weeks of the basic federal income tax course, many of which boil down to this: Is there gross income? As noted and renoted above, the mere fact that you receive cash does not mean that you have income. If, for example, the cash merely offsets your basis in an asset disposed of, you have no gain on disposition and therefore no income. And remember that certain recoveries might be tax-free for other reasons even if an economist or other tax theorist would disagree. Maybe we think Congress would really not have intended to tax the benefit (one interpretation of *Gotcher*), or maybe we think that imposing an income tax on certain sorts of recoveries would be unseemly (one way the revenue rulings dealing with recoveries for persecution might be understood).

One way to help with the *is-it-income?* determination is to go back to a test used in many cases and rulings, including *Murphy I*: ask what the recovery was “in lieu of.” The case always cited for this proposition is *Raytheon Production Corp. v. Commissioner*,³⁵² which was decided by the First Circuit in 1944. To the extent a recovery substitutes for amounts that would have been taxable, like lost profits, the recovery should be taxable if section 104(a)(2) does not apply.³⁵³ To the extent it does not take the place of an otherwise taxable item,

³⁵¹ There would be other issues under today’s Code, if the benefit were not treated as automatically excludable. Had these expenditures been made by *Gotcher* himself, they might have been treated as start-up expenditures because he was investigating the creation of a trade or business. If so, the expenditures might have been amortizable later even if not currently deductible. See I.R.C. § 195 (2006).

³⁵² 144 F.2d 110 (1st Cir. 1944).

³⁵³ See *id.* at 113.

however, it should not automatically be taxable—unless it is just a windfall.³⁵⁴ In sum, if the amount received is not in lieu of anything, and assuming no specific exclusion applies, it should be taxed.³⁵⁵

The “in lieu of” test has been disparaged in recent commentary. For one thing, it has been characterized as arising in the commercial damages context, and consequently lacking any obvious relevance to personal injury recoveries. Professor Dodge has written:

The only respectable (if dangerously incorrect) basis for excluding compensatory damages from gross income is the “substitute for” theory, which may be loosely related to the *Raytheon* case. That case (and its progeny) dealt with the issue of whether commercial damages were “for” lost profits or a destroyed asset with a basis. Not only were these cases concerned with commercial damages, they ultimately hinged on a finding (or nonfinding) of recoverable basis. They do not stand for the proposition that a cash recovery for personal injury is excludible apart from basis recovery or section 104(a)(2).³⁵⁶

Raytheon did involve commercial damages, but it is unclear why a principle developed in one context cannot apply in another. Whatever its origins, the “in lieu of” or “substitute for” test has been used often in personal injury cases by courts oblivious to the “danger” involved.³⁵⁷

Indeed, in *O’Gilvie v. United States*,³⁵⁸ decided in 1996, the Supreme Court took application of the test for granted in determining whether punitive damages associated with a personal injury were excludable under the pre-1996 version of section 104(a)(2). In describing that section, Justice Breyer noted that “the language

³⁵⁴ See *id.*

³⁵⁵ See *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

³⁵⁶ Dodge, *Jensen’s Missiles*, *supra* note 16, at 987; see also Geier, *supra* note 76, at 578 (discussing origins of the “in lieu of” test).

³⁵⁷ See, e.g., *Delaney v. Comm’r*, 99 F.3d 20, 23–24 (1st Cir. 1996) (applying test to determine the consequences of a tort settlement); *Robinson v. Comm’r*, 102 T.C. 116 (1994) (same), *aff’d in part & rev’d in part*, 70 F.3d 34 (5th Cir. 1995), *superseded by statute*, Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838, *as recognized in* *Moulton v. Comm’r*, 97 T.C.M. (CCH) 1151 (2009); see also *Moulton*, 97 T.C.M. (CCH) 1151 (same); *Gibson v. Comm’r*, 94 T.C.M. (CCH) 164 (2007) (applying test to determine the applicability of section 104(a)(2)); *Connolly v. Comm’r*, 93 T.C.M. (CCH) 1138 (2007) (same); *Green v. Comm’r*, 90 T.C.M. (CCH) 436 (2005) (same); cf. *Getty v. Comm’r*, 913 F.2d 1486 (9th Cir. 1990) (applying test to determine that a settlement payment made by the Getty Museum to the Getty family heirs was excludable to the extent it was in lieu of a gift by J. Paul Getty).

³⁵⁸ 519 U.S. 79 (1996).

excludes from taxation not only those damages that aim to *substitute for* a victim's physical or personal well-being—the inference was that that portion of the damages might not have been taxable regardless of section 104(a)(2)—but also “those damages that *substitute . . . for* lost wages, which would have been taxed had the victim earned them.”³⁵⁹ In contrast, punitives substituted for nothing and were therefore outside the scope of the exclusion.³⁶⁰ The “substitute for” language was dictum, and the language might not have resulted from careful deliberation. But the language resonated with some Justices.

The test is not perfect, and it might need tweaking. But it at least requires asking some questions we should be asking anyway. What is the payment for?³⁶¹ (Is it basis recovery, a windfall, effectively for disposition of an asset with a zero basis?) Or, more generally—this is what we ought to be figuring out—what is going on here? Judgment, and sometimes guesswork, will be involved, but I cannot imagine determining the tax consequences of *any* event or transaction without making the effort to determine what really was going on.³⁶²

If Professor Dodge means only that the cases in which courts have applied the “in lieu of” test have not used it as an independent ground for exclusion, then of course I agree.³⁶³ The test does not lead to any particular conclusion. We determine, as best we can, what a recovery was for, and then we go from there. If the recovery replaced lost profits, then it is taxable (assuming no other basis for exclusion exists). If not, keep thinking.³⁶⁴

³⁵⁹ *Id.* at 86 (emphasis added).

³⁶⁰ *See id.*

³⁶¹ *See, e.g.,* I.R.S. Priv. Ltr. Rul. 2009-03-073 (Oct. 9, 2008) (applying test to determine the portion of recovery excludable by section 104(a)(2) and the portion attributable to punitives). In this ruling, the Service conflated the “in lieu of” and “origin of the claim” tests. *Cf. Phelps v. Comm’r*, 95 T.C.M. (CCH) 1336, 1340 (2008) (“If the settlement agreement lacks express language stating what the amount paid pursuant to that agreement was to settle, the intent of the payor is critical to that determination.”).

³⁶² *Cf. Lyeth v. Hoey*, 305 U.S. 188 (1938) (holding that an amount received under a compromise about a contested will was received by “inheritance” for purposes of statutory exclusion, when Lyeth was able to receive what he did only because he was an heir and he made a claim in that capacity).

³⁶³ *See Dodge, Jensen’s Missiles*, *supra* note 16, at 131 (“The ‘in lieu of’ (or ‘substitute for’) theory is thrown around as if the mere labels attached to the doctrine lead to obvious conclusions.”).

³⁶⁴ Professor Dodge thinks an exclusion would be available only if section 104(a)(2) applies or recovery of basis is involved. *See supra* text accompanying note 356. That is a respectable point, but it does not speak to the value of the “in lieu of” test. And while Professor Geier is right that “*Raytheon* does not stand for the proposition that a damage award made in lieu of an item that would not, itself, be taxable is not gross income,” Geier, *supra* note 76, at 578, many hints in cases and rulings suggest we take that factor into account. *See, e.g., O’Gilvie*, 519 U.S. at 86.

Just as Professor Dodge would like to limit the “in lieu of” test to cases involving commercial damages, the district court in *Murphy* restricted the scope of the test: “courts have applied the *Raytheon* test in cases involving settlement, not in cases where damages are awarded by an administrative body.”³⁶⁵

My response is the same as to Professor Dodge: So? The test can be hard to apply, and it will often not lead to definitive answers, but the distinction drawn by the district court is bizarre. The way the administrative law judge broke down the award in *Murphy* made characterization easier than would be true with a settlement agreement. The total recovery was divided into two components—\$45,000 for “mental pain and anguish” and \$25,000 for “damage to her professional reputation”³⁶⁶—a helpful first step, particularly when done by a disinterested party. It is hard to see why this situation *worsens* the case for application of the “in lieu of” test.³⁶⁷

More generally, how might the characterization of a damages recovery proceed? Professor Andrews raises a nice conceptual puzzle in his income-tax casebook: Assume that a recovery for a physical personal injury is broken into various components—lost income, medical expenses, pain and suffering, punitives, and so on. Would any of the recovery be excludable if there were no section 104(a)(2)?³⁶⁸

The issue does not come up in the real world with a physical injury recovery because the full amount is generally excludable anyway—except for the punitives and, if the medical expenses had previously been deducted, the amount attributable to those expenses.³⁶⁹ But suppose section 104(a)(2) were repealed. Would the repeal indicate a congressional intention to tax the full amount of any recovery for a physical injury recovery? Would, for example, a recovery of medical expenses not previously deducted by the victim suddenly become taxable in a world without section 104(a)(2)? Of course not.³⁷⁰ Would

³⁶⁵ *Murphy v. IRS*, 362 F. Supp. 2d 206, 218 (D.D.C. 2005), *aff'd*, 493 F.3d 170, 172 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

³⁶⁶ *Id.* at 215.

³⁶⁷ Ultimately the merits of the test did not matter to the district court, which concluded that the default rule was “income” and a statutory exclusion did not apply. Moreover, exclusions must be “narrowly construed.” *Id.* at 213 (quoting *United States v. Burke*, 504 U.S. 229, 248 (1992) (Souter, J., concurring in judgment)).

³⁶⁸ WILLIAM D. ANDREWS, *BASIC FEDERAL INCOME TAXATION* 105 (5th ed. 1999). The question survives in the new edition. See WILLIAM D. ANDREWS & PETER J. WIEDENBECK, *BASIC FEDERAL INCOME TAXATION* 96 (6th ed. 2009).

³⁶⁹ See *supra* note 187.

³⁷⁰ If the recovery occurs in the same year as the expense, and the victim is able to deduct the expense under section 213 of the Code, the effect is a wash: no net income. To the extent the expense is not deductible (if, for example, the threshold under section 213 is not reached), we have basis recovery.

a pain-and-suffering component of the recovery be includable in gross income? I am not sure, but I am sure that the answer is not so obviously yes that the question should be ignored.

One traditional line of analysis concludes that a pain-and-suffering recovery should be tax-free because it substitutes for the “right to be free from pain and suffering,” which is not included in the income tax base. (Justice Breyer hinted at the propriety of that treatment in *O’Gilvie*,³⁷¹ and the *Murphy I* panel applied that analysis in connection with the emotional-distress recovery.³⁷²) If you lose \$1,000 worth of emotional well-being and are compensated with a \$1,000 recovery, you will not be made whole if you are taxed.³⁷³ Maybe it does not make sense to talk in these terms, but people do.³⁷⁴ And if you have really lost something, it does not seem appropriate to automatically characterize any recovery as a windfall.³⁷⁵

However we analyze that part of a recovery, the ultimate question is whether there is income; we would not assume that, simply because no express exclusion applies, the recovery is taxable. Professor Andrews included the alienation-of-affections ruling in his text, apparently intending students to ponder whether there might be justification for not taxing at least part of a personal injury recovery on the ground that there is no income.³⁷⁶

In the cases and rulings that have applied the “in lieu of” test in a personal physical injury setting, the question has usually been whether a recovery is “on account of” a physical injury, not to break a recovery into components (other than to determine any element of

³⁷¹ See *supra* text accompanying note 359. Until *Murphy*, that argument seems not to have been raised in post-1996 cases involving recoveries for nonphysical injuries with something like a pain-and-suffering aspect. See, e.g., *Venable v. Comm’r*, 86 T.C.M. (CCH) 254 (2003), *aff’d*, 110 F. App’x 421 (5th Cir. 2004) (not considering exclusion of a mental-anguish portion of malicious-prosecution recovery).

³⁷² See *Murphy I*, 460 F.3d 79, 88 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

³⁷³ The relief provision available for involuntary conversions of property would be unavailable in this situation. See I.R.C. § 1033 (2006); see also *supra* note 256.

³⁷⁴ Professor Dodge has argued that “pain-and-suffering damages compensate that which cannot be purchased. Thus, it is fundamentally misleading to call these damages ‘compensation’; they ‘replace’ the irreplaceable.” Dodge, *Taxes and Torts*, *supra* note 196, at 183. That is a powerful rhetorical point. Nevertheless, we will continue talking about “compensation” for irreplaceable losses. (Furthermore, Dodge’s flourish would not strike the man on the street as *support* for imposing tax liability.)

³⁷⁵ But see *infra* note 414 and accompanying text (describing an early Treasury ruling concluding that recovery for pain and suffering was taxable in the absence of a statutory provision to the contrary).

³⁷⁶ That was true in the 1999 edition, see ANDREWS, *supra* note 368, and, in the new edition, Andrews and Wiedenbeck again include Revenue Ruling 74–77, 1974-1 C.B. 33. See ANDREWS & WIEDENBECK, *supra* note 368, at 99. Neither edition informs students that the Service has pulled the ruling.

punitive damages).³⁷⁷ A further breakdown is generally unnecessary because, if it is applicable, section 104(a)(2) potentially makes the entire recovery excludable.

With nonphysical personal injuries, however, the cases and rulings after the 1996 amendment to section 104(a)(2) have not even mentioned the possibility of breaking down a recovery into clearly taxable and possibly nontaxable components. But exactly the same analytical structure used with the Andrews hypothetical is appropriate with a recovery for a nonphysical injury, where section 104(a)(2) has no application.

One reason this has not happened is because of the pervasive idea that a recovery for a nonphysical personal injury is taxable. In unthinkingly accepting an all-or-nothing rule—if a recovery is on account of a personal nonphysical injury, it is fully taxable; if it is on account of a physical personal injury, it is generally nontaxable—taxpayers, lawyers, and courts have not thought about the possibilities that the “in lieu of” test suggests. Or if they have thought about the possibilities, taxpayers’ lawyers have decided that fighting city hall is pointless. When the facts are right, however, clients should be advised to do exactly that.

One more set of points is worth making in defense of the “in lieu of” test. Professor Geier has argued that the test, if taken literally, leads to absurd results. Should the punitive damages or antitrust treble damages in *Glenshaw Glass* have been tax-free because they were “in lieu of being free from the defendant’s particularly egregious behavior”?³⁷⁸ The taxpayers in *Glenshaw Glass* would not have been taxed on the value of the right to be free from egregious conduct.

This imaginative criticism is unconvincing, for two reasons. First, the damages in *Glenshaw Glass* did not substitute for anything. That was the point,³⁷⁹ and it was emphasized in *O’Gilvie* as well.³⁸⁰ To the extent that a “recovery” is a pure windfall, it ought to be taxable. Second, if the “in lieu of” test leads to absurd results when taken too

³⁷⁷ See, e.g., I.R.S. Priv. Ltr. Rul. 2009-03-073 (Oct. 9, 2008) (mandating application of a test to determine the portion of recovery excludable under section 104(a)(2) as “on account of personal physical injuries” and the portion attributable to punitives).

³⁷⁸ Geier, *supra* note 76, at 578.

³⁷⁹ The *Glenshaw Glass* Court noted:

Respondents concede . . . that the recoveries are taxable to the extent that they compensate for damages actually incurred [i.e., lost profits]. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury.

Comm’r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

³⁸⁰ See *supra* notes 358–59 and accompanying text.

literally, we should not take it so literally. As I suggested earlier, “What is going on here?” works as well as we can expect. Phrased in that inelegant way, the test leads to the proper result: if nothing has been lost and cash has been received, the damages must be fully taxable. We should not expect more linguistic precision, and more predictability in result, than is possible in applying legal tests.

D. The Bottom Line: Not All “Nonphysical” Recoveries Are Taxable

The discussion in this part of the Article has gone in several directions, but with a common theme: those who have assumed that the receipt of value is, absent a specific statutory exception to the contrary, automatically taxable under the Internal Revenue Code are just wrong. And that has been true even in cases when the value received was in the form of cash and no apparent basis offset was involved.

There is no reason to assume that a recovery for a nonphysical personal injury is automatically taxable. Full inclusion in the recipient’s gross income is the likely result in most cases, to be sure, but it should not be the result in all. At a minimum, authority—doctrine!—has supported the propositions that no income arises in cases of basis recovery; for recoveries where a personal right was lost; perhaps in cases where many might think it unseemly to impose an income tax; and who knows what else? When the Internal Revenue Service recently pulled authority supporting those positions, it did so without adequate justification, and, in some cases, it did so for a questionable reason: to further its litigation posture in *Murphy*.

Theoreticians might not like all of that authority, but some of it is unobjectionable (basis recovery) and all of it has (or had) been around for a long time. Doctrine should not be ignored simply because a commentator thinks it is theoretically unfounded.

VI. WHY THE RESULT IN *MURPHY* WAS NOT CRAZY

One of the points I have been making is that the concept of income historically was not as all-encompassing as modern commentators think it should have been. The case can reasonably be made that Ms. Murphy might not have had gross income as defined in section 61, at least not to the extent of the full \$70,000—a determination that the D.C. Circuit did not make in *Murphy I*, except implicitly, by jumping straight to the constitutional issues—and that her recovery was not necessarily “incomes” under the Sixteenth Amendment.

In *Murphy I*, the panel said it was making two big points. First, the recovery was not “in lieu of” anything that would have been

taxable,³⁸¹ and, although that point by itself might not have been determinative, it was bolstered by point 2: Damage recoveries for personal injuries would not have been understood as “income” by the ratifiers of the Sixteenth Amendment, except insofar as the recoveries were for lost wages or profits.³⁸² Neither of these points is crazy. A third point underlies much of the panel’s discussion: Although the panel purported not to rely on any “return of capital” theory, that idea clearly played a central role in its thinking about the meaning of “income.”³⁸³ The point was expressed using howler-like language, but it too was not baseless. I will discuss each of these three points.

In addition, I shall discuss other factors that might have helped justify the result in *Murphy I*, even though the panel did not stress (or even mention) them. First, the old cases and rulings in this area have distinguished, or have been understood to have distinguished, between recoveries associated with voluntary events and those associated with involuntary ones—with recoveries for events that fall on the involuntary side of the divide less likely to be taxable. The voluntary-involuntary distinction has intuitive appeal today, as it would have had in 1913. Second, contrary to the position taken by several commentators, Murphy’s recovery for emotional distress was not equivalent to wages. And I shall discuss the limits of logic in understanding legal doctrine—that some see a logical connection between wages and emotional-distress recoveries does not mean the law must accept their equivalence—and the suspect idea that “income” is a legal concept that can evolve on its own, with no changes in the underlying statutory or constitutional scheme.

A. The “In Lieu of” Test Applied to Murphy

The *Murphy I* panel applied the “in lieu of” test to determine whether Ms. Murphy’s recovery, none of which was for lost wages, should have been included in the income-tax base.³⁸⁴ The answer was no: the “emotional well-being and good reputation [Murphy] enjoyed before they were diminished by her former employer were not taxable as income. Under this analysis, . . . the compensation she received in lieu of what she lost cannot be considered income.”³⁸⁵

³⁸¹ See *Murphy I*, 460 F.3d 79, 88 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

³⁸² *Id.*

³⁸³ “The question in this case is not . . . about a return of capital—except insofar as Murphy analogizes human capital to physical or financial capital; the question is whether the compensation she received for her injuries is income.” *Id.*

³⁸⁴ See *id.*

³⁸⁵ *Id.*

The panel's use of the test caused critics to go ballistic, but, as I discussed in Part V.C, there was ample authority to support this sort of analysis. Put "analysis" in quotation marks if you wish, but in *O'Gilvie* the Supreme Court had implied that this was a relevant consideration.³⁸⁶ And it certainly would have been relevant if the "in lieu of" test had led to the conclusion that the recovery substituted for lost profits and therefore should have been taxable. Had that determination been made, no one would be complaining about use of the test.

Judge Ginsburg wrote that, because of *O'Gilvie*, his panel had been "instructed" by the Supreme Court to engage in this inquiry.³⁸⁷ He overstated the extent to which the Court had required use of the test, or had mandated that a recovery should be tax-free if it substituted for nontaxable attributes. On the other hand, Ginsburg did not make this stuff up. Commentators might think the Supreme Court had gotten the analysis bizarrely wrong, or that the D.C. Circuit panel might have worked its way around an apparent directive. But the panel does not deserve criticism—no howler here—for doing what it reasonably thought it was supposed to do.

B. Return of Capital Ideas

The *Murphy I* panel characterized Murphy's "return of capital" argument as follows:

Murphy argues that, being neither a gain nor an accession to wealth, her award is not income and § 104(a)(2) is therefore unconstitutional insofar as it would make the award taxable as income. Broad though the power granted in the Sixteenth Amendment is, the Supreme Court, as Murphy points out, has long recognized "the principle that a restoration of capital [i]s not income; hence it [falls] outside the definition of 'income' upon which the law impose[s] a tax."³⁸⁸

Murphy then argued that the same principles reflected in the language quoted from *O'Gilvie* should apply to a conversion of human capital.³⁸⁹

I have noted the panel's unfortunate failure to distinguish between

³⁸⁶ See *O'Gilvie v. United States*, 519 U.S. 79, 84, 86 (1996).

³⁸⁷ *Murphy I*, 460 F.3d at 88.

³⁸⁸ *Id.* at 85 (alterations in original) (quoting *O'Gilvie*, 519 U.S. at 84).

³⁸⁹ *Id.* (citing GARY S. BECKER, *HUMAN CAPITAL* (1st ed. 1964); Gary S. Becker, *The Economic Way of Looking at Life*, in *ECONOMIC SCIENCES* 27, 43–45 (Nobel Lecture, Dec. 9, 1992)).

“returns of capital” and “returns of basis.”³⁹⁰ That is a howler of sorts, but, as was true with use of the “in lieu of” test, the panel was doing what it thought it was supposed to do. Murphy was able to quote helpful language not only from *O’Gilvie* but also from *Glenshaw Glass*:

The long history of . . . holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.³⁹¹

Glenshaw Glass was a statutory interpretation case, not one arising under the Sixteenth Amendment, but, given the historical understanding that “gross income” under section 61 of the Code and “incomes” in the Amendment should be interpreted in a consistent way, it was hard not to make the jump from statutory analysis to constitutional interpretation.³⁹²

Critics have ridiculed *Murphy I*, but the Supreme Court really had said that about “returns of capital,” and as recently as 1996.³⁹³ Yes, those passages were dicta—and, in *Glenshaw Glass*, dictum in a footnote³⁹⁴—but they were Supreme Court dicta. In both cases, the Court was making the point that punitive damages could not be treated as compensatory and therefore could not be tax-exempt in the way that compensatory damages might be (at least to the extent basis recovery is involved). If the Court had been more focused, it might have seen the important distinction between returns of basis and “returns” of unrealized appreciation.³⁹⁵ Or the Court might have said

³⁹⁰ See *supra* Part III.

³⁹¹ *Murphy I*, 460 F.3d at 85 (omission in original) (quoting *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955)).

³⁹² The *Murphy* panel stated:

Fortunately, we need not rely solely upon the wisdom and beneficence of the Congress for, when the Sixteenth Amendment was drafted, the word “incomes” had well understood limits. . . . [T]he power to tax income extends only to “gain[s]” or “accessions to wealth.” That is why . . . the Supreme Court has held a “return of capital” is not income.

Id. at 88 (alteration in original) (quoting *Glenshaw Glass*, 348 U.S. at 430–31) (citing *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 187 (1918); *S. Pac. Co. v. Lowe*, 247 U.S. 330, 335 (1918)).

³⁹³ *O’Gilvie*, 519 U.S. at 84.

³⁹⁴ See *Glenshaw Glass*, 348 U.S. at 432 n.8.

³⁹⁵ See 1 BITTKER & LOKKEN, *supra* note 172, ¶ 5.6, at 5-39 (arguing that the Court’s observation in *Glenshaw Glass* “was probably intended only to distinguish the rulings, not to

that in the personal injury context we should care only about whether there has been a return of “capital,” regardless of basis, because that is how the law has been understood since the inception of the income tax. The Court did none of that.

Those who assign *Glenshaw Glass* to the tax-cases hall of fame need to realize that this confusing, if not embarrassing, material is in that opinion³⁹⁶ and that, if closely read, *Glenshaw Glass* cannot be interpreted as having advanced our understanding of “income” except in the most trivial sense.³⁹⁷ The issue in *Glenshaw Glass* was so easy that the case tells us little about difficult interpretive issues. In the best tradition of judicial restraint, something he was not otherwise known for, Chief Justice Warren challenged precedent only at the margins. In getting to the right result,³⁹⁸ he took questionable propositions at face value and muddled the waters.

Given what the Supreme Court had written in *O’Gilvie* and *Glenshaw Glass*, the D.C. Circuit panel had justification for making too much of Murphy’s return-of-capital argument. In addition, the panel was reacting to the government’s dumb argument that Murphy should have been taxed because she had received cash.³⁹⁹ That “breathtakingly expansive claim” gave credibility to the return-of-capital idea. A party that takes an extreme position risks losing the high ground and endangers the more reasonable result for which it might have advocated.

C. What Did “Income” Mean in 1913?

The *Murphy I* panel made a good-faith, although incomplete, effort to understand the early history of the tax treatment of personal injury recoveries. If we need to understand what “income” meant in 1913 or thereabouts, we should use the best authority we can find.

Many commentators do not care what people thought in 1913, but

endorse them”).

³⁹⁶ It is embarrassing unless the rules are different in the personal injury context. Maybe we should not have to worry about the application of generally applicable rules in unusual situations. See *supra* Part V.B.

³⁹⁷ I find the reverence shown to *Glenshaw Glass* unfathomable. See, e.g., Joseph M. Dodge, *The Story of Glenshaw Glass: Towards a Modern Concept of Gross Income*, in TAX STORIES, *supra* note 8, at 17, 53 (“*Glenshaw Glass* . . . is now recognized as a classic for setting tax jurisprudence firmly on a modern footing. ‘Modern’ means free of the clutter and distractions inherited from the nineteenth century and the early twentieth century.”); see also *supra* text accompanying note 14.

³⁹⁸ The result was right, but, as he often did in tax cases in which the government prevailed, Justice Douglas dissented without opinion. See *Glenshaw Glass*, 348 U.S. at 433 (Douglas, J., dissenting).

³⁹⁹ See *supra* notes 78–80 and accompanying text.

Judge Ginsburg wrote that the Supreme Court—it does get in the way!—had “instructed that, in defining ‘incomes,’ we should rely upon ‘the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment.’”⁴⁰⁰ On this issue, the judge was right about the directive from the higher Court. That quotation was from a 1921 case, but it was not dictum and the Court has not repudiated it.⁴⁰¹ Whether or not the D.C. Circuit had really been “instructed” to apply the “in lieu of test” or to use “return of capital” ideas, there was no doubt that, on discerning the meaning of the Amendment, the Court had issued “instructions.”

What is a lower court to do when presented with Supreme Court statements that contradict propositions that are taken for granted in the legal academy? A scholar might answer, “Look to my theory,” and certainly a lower court can parse and distinguish Court language. On the application of a “return-of-capital” doctrine, for example, a *Murphy I* critic might conclude that the Court could not possibly have meant to suggest that a recovery of capital, as distinguished from basis, is always tax-free in the personal injury setting.

But when it comes to understanding the Sixteenth Amendment, Supreme Court dictates leave no wiggle room.⁴⁰² The *Murphy I* panel was required to do what it did, if the term “incomes” was relevant to resolution of the case.⁴⁰³ We might think today’s Court would require a different analysis, but we cannot know that for sure. And the Court has instructed lower courts not to reject its precedents. The Court itself must inter suspect authority.⁴⁰⁴

⁴⁰⁰ *Murphy I*, 460 F.3d 79, 88–89 (D.C. Cir. 2006) (quoting *Merchs’ Loan & Trust Co. v. Smietanka*, 255 U.S. 509, 519 (1921)), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

⁴⁰¹ Even Justice Holmes, dissenting in *Macomber*, agreed that the meaning of the Amendment at ratification should be given effect. See *Eisner v. Macomber*, 252 U.S. 189, 220 (1920) (Holmes, J., dissenting) (stating that “[t]he known purpose of [the Sixteenth] Amendment was to get rid of nice questions as to what might be direct taxes”). Holmes disagreed with his brethren about what that meaning was.

⁴⁰² When the meaning of “direct tax” was at issue in *Murphy II*, the panel felt it was required to follow Supreme Court precedent—difficult given the unprincipled character of the cases—even though it seemed to think that precedent was inconsistent with original understanding. See *Murphy II*, 493 F.3d 170, 184–86 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008); see also *infra* Part VII. Since the panel cited me, I know it had a good sense of what the original understanding was. See *Murphy II*, 493 F.3d at 182, 183.

⁴⁰³ In *Murphy II*, the panel avoided this issue by determining that the Amendment was irrelevant, but the Amendment was clearly relevant to the *Murphy I* analysis. See *Murphy II*, 493 F.3d at 185; *Murphy I*, 460 F.3d at 84–92.

⁴⁰⁴ See *Agostini v. Felton*, 521 U.S. 203, 237 (1997) (reaffirming “that ‘[i]f a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions’” (alteration in original) (quoting

It is impossible to be certain whether an emotional-distress recovery with no lost-income component would have been thought of as “income” in 1913. One can be sure, however, that taxing this sort of thing was not what motivated proponents of the Sixteenth Amendment: the goal was to overturn *Pollock* and make sure that income from property of the rich could be taxed without regard to the direct-tax apportionment rule.⁴⁰⁵ In fact, I am reasonably sure that, if we could have asked an Amendment proponent about an emotional-distress recovery, the response would have been “Huh?”

Because there was no direct evidence of 1913 thinking on this issue, the *Murphy I* panel did the best it could, looking to nearly contemporaneous authority. Encouraged by passages in *O’Gilvie*, Murphy’s lawyers urged the panel to look at a 1918 Opinion of the Attorney General, a 1918 Decision of the Department of the Treasury, and a report issued by the House Ways and Means Committee on the Revenue Act of 1918,⁴⁰⁶ all of which pointed toward no taxation on statutory grounds, and maybe on constitutional ones as well.⁴⁰⁷

The panel’s statutory analysis and constitutional analysis were collapsed. That is hard to avoid, and, given the assumed relationship between the statutory meaning of “gross income” and the Sixteenth Amendment meaning of “incomes,” such consolidation was not a mark of confusion. After all, it was not until *Murphy II* that a court decided that no connection needed to exist.

In the first post-Amendment revenue statutes, Congress was silent about taxing personal-injury recoveries. Not until the Revenue Act of 1918 did Congress speak, excluding from gross income “[a]mounts received, through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.”⁴⁰⁸

That provision is usually understood as having made no physical-nonphysical distinction, and that is probably right, although

Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 484 (1989)).

⁴⁰⁵ See *supra* Part IV.A.

⁴⁰⁶ See *Murphy I*, 460 F.3d at 86.

⁴⁰⁷ Unfortunately, other, more negative authority that might have been relevant was not brought to the panel’s attention until *Murphy II*. See *infra* notes 414–21 and accompanying text. It is probably unfair to criticize the government for not having provided these citations to the panel; the government could not predict the direction that the *Murphy I* panel’s deliberations would take. Nevertheless, this is another instance in which the panel was flying blind, without adequate guidance.

⁴⁰⁸ See Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

not clearly so. On the one hand, the language might be read as having no application to most nonphysical personal injury recoveries: how could accident or health insurance have anything to do with a garden-variety recovery for libel? But some nonphysical injuries could be covered by health insurance—those having to do with psychiatric or psychological damage—and such a recovery should have been nontaxable under the statute.

Why did Congress adopt such language? According to the House report on the legislation, it was to clarify the law, not necessarily to change it: “Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen’s compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income.”⁴⁰⁹

The *Murphy I* panel pointed to two other contemporaneous documents—a 1918 opinion of the Attorney General and a 1918 Treasury Decision—that it said led to the same conclusion, “that the term ‘incomes’ as used in the Sixteenth Amendment does not extend to monies received solely in compensation for a personal injury and unrelated to lost wages or earnings.”⁴¹⁰

The Secretary of the Treasury had asked the Attorney General whether proceeds under an accident insurance policy were income prior to the 1918 Act. It is here that the restoration-of-capital idea had its origins:

Without affirming that the human body is in a technical sense the “capital” invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of *future* periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore “capital” as distinguished from “income” receipts.⁴¹¹

The Treasury extended that position in its 1918 decision: “upon similar principles . . . an amount received by an individual as the result of a suit or compromise for personal injuries sustained . . .

⁴⁰⁹ H.R. REP. NO. 65-767, at 9–10 (1918).

⁴¹⁰ *Murphy I*, 460 F.3d at 89.

⁴¹¹ 31 Op. Att’y Gen. 304, 308 (1918). Professor Dodge cites one of the fathers of the modern income tax, Edwin Seligman, for the proposition that the “notion of income around the time of the 16th Amendment and the 1913 enactment of an income tax law excluded nonrecurring receipts.” Dodge, *Taxes and Torts*, *supra* note 196, at 150 n.43 (citing SELIGMAN, *supra* note 180, at 19–22, 677–85).

through accident is not income taxable [under the Revenue Acts of 1916 and 1917].”⁴¹²

The result of all of this, concluded the *Murphy I* panel, is that codification of the no-income rule should not be understood to mean that the prior understanding was “income.”⁴¹³ The 1918 statute was for purposes of clarification.

Things were not as straightforward as the *Murphy I* panel suggested, however. In fact, the Treasury’s position before 1918 was that such recoveries were *taxable*. That position was reflected in two decisions that the *Murphy I* panel must not have been aware of. A 1915 Treasury decision had provided that, under the Revenue Act of 1913, which included no provision for personal injury recoveries,

[a]n amount received as the result of a suit or compromise for “pain and suffering” is held to be such income as would be taxable under the provision of law that includes “gains or profits and income derived from any source whatever.” An amount thus received would be, in its nature, similar to an amount paid to a person insured by an accident insurance policy on account of an accident sustained.⁴¹⁴

If a pain-and-suffering component is taxable, then *a fortiori* any lost-income component would be as well.⁴¹⁵ Similarly, in 1917 Treasury announced that, under the War Revenue Act of October 3, 1917, “[p]ayments made to an injured employee by a corporation under the accident compensation laws of the several States constitute taxable income of the employee.”⁴¹⁶

One would expect Treasury to be aggressive in defining “income,” and its views should not automatically be controlling. In any event, it was only with the 1918 decision extending the Attorney General’s analysis that Treasury changed direction. The change came about because of judicial decisions that, by today’s standards, reflect an unsophisticated view of basis. The Attorney General quoted from the Sixth Circuit opinion in *Doyle v. Mitchell Brothers Co.*,⁴¹⁷ concluding that sale of capital assets cannot generate income because a sale is value for value.⁴¹⁸ The Attorney General ruled such recoveries were

⁴¹² T.D. 2747, 20 Treas. Dec. Int. Rev. 457, 457 (1918).

⁴¹³ *Murphy I*, 460 F.3d at 88.

⁴¹⁴ T.D. 2135, 17 Treas. Dec. Int. Rev. 39, 42 (1915).

⁴¹⁵ Did Treasury mean to imply that the portion of a recovery relating to medical expenses would be taxable? Surely not, unless the recovery was for amounts previously deducted.

⁴¹⁶ T.D. 2570, 19 Treas. Dec. Int. Rev. 321, 323 (1917).

⁴¹⁷ 235 F. 686 (6th Cir. 1916), *aff’d*, 247 U.S. 179 (1918).

⁴¹⁸ See 31 Op. Att’y Gen. at 307–08.

effectively returns of capital and not taxable.⁴¹⁹

Even then, however, the Bureau of Internal Revenue mounted a rearguard action. In 1919 it concluded—this is the full text of a memorandum—that “[m]oney recovered as damages in libel proceedings is subject to income tax,”⁴²⁰ with no indication that it might matter whether a libel action was personal in nature. And in a 1920 memorandum, noted earlier, the Bureau concluded that the statutory exclusion for recoveries for “personal injuries” ought to be interpreted to apply only to physical injuries, and that an alienation-of-affections recovery was therefore probably taxable because nothing like a “conversion of the capital” had occurred.⁴²¹

It was only after 1920 that administrative understanding moved clearly to the “no income” position reflected in rulings, described earlier, dealing with recoveries for alienation of affections and similar torts.⁴²² The motivating factor for reversal was *Eisner v. Macomber*⁴²³ and a new focus on the constitutional meaning of “incomes.” Once the Supreme Court had sensitized Treasury officials to constitutional issues, Treasury fell into line.

Because the history is not clear—even as described by the *Murphy I* panel, it was murky—we need to think about how lack of clarity should be treated. One possibility is the one commonly advanced by commentators: if there is doubt, the taxing power triumphs, and no limitation should be inferred. Or one can imagine the other extreme: if there is doubt about whether a levy should be exempted from a constitutional limitation like the apportionment rule, the limitation should be deemed to apply.

In this case, a middle ground has appeal. The *Murphy I* panel concluded that a lost profits or wages component of a personal injury would fit within the Sixteenth Amendment’s meaning of “incomes”—not *Murphy*’s situation⁴²⁴—but the distinction between lost profits and other possible components of a personal injury recovery was not explicit in any of the authorities discussed above. Nor does it seem

⁴¹⁹ *Id.*

⁴²⁰ Sol. Mem. 957, 1 C.B. 65, 65 (1919).

⁴²¹ Sol. Mem. 1384, 2 C.B. 71, 72 (1920); see also *supra* notes 234–35 and accompanying text. The Bureau did note, however, that, to the extent the award was attributable to “sickness” resulting from alienation of affections, the statutory exclusion would apply. Sol. Mem. 1384, 2 C.B. at 72.

⁴²² See *supra* Part V.B.2.a.

⁴²³ 252 U.S. 189 (1920); see also *supra* notes 129–36 and accompanying text.

⁴²⁴ See *Murphy I*, 460 F.3d 79, 91 (D.C. Cir. 2006) (“Because, as we have seen, the term ‘incomes,’ as understood in 1913, clearly did not include damages received in compensation for a physical personal injury, we infer that it likewise did not include damages received for a nonphysical injury and unrelated to lost wages or earning capacity.”), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

to have motivated the legislation or discussions in the early post-Amendment period. But might we not assume that, had the ratifiers of the Amendment thought about the issue, they would have agreed that a lost-profits recovery could be taxed, even if a recovery for, say, pain and suffering, could not be?⁴²⁵ This distinction may have constitutional implications, with Congress left to decide whether to impose a tax on the lost-profits component.

The goal of the tort system was to make the victim of a personal injury as close to whole as possible. In the post-*Macomber* decisions, like Solicitor's Opinion 132, the government was trying to reflect the constitutional understanding of *Macomber*, and concluded that someone who recovers for loss of a purely personal right cannot be held to "derive[] any gain or profit."⁴²⁶ With no accession to wealth deemed to have taken place, taxing a recovery would therefore have not left the victim whole. Similarly, the *Hawkins* case, concluding that a recovery for libel and slander was tax-free when the damage was only to personal reputation, stressed the goal as "attempt[ing] to make the plaintiff whole as before the injury."⁴²⁷

If that is the goal, treating a lost-profits component of a recovery as taxable makes sense: tax a recovery of what would have been taxed anyway. That would have been understood in 1913, if Amendment proponents had been thinking about the issue. Go beyond lost profits (and punitives), however, and, reading the authorities informed by what the Amendment was intended to accomplish, I am skeptical that most folks would have thought of a recovery as income.

One float in the parade of horrors that started after *Murphy I* was the fear that locking the income-tax system into a 1913 conception of income could require removing many items from the modern income-tax base.⁴²⁸ We have come to take the taxability of many items for granted, whatever the understanding was in 1913.⁴²⁹

Time has passed some arguments by. But the constitutional issues associated with personal injury recoveries have arisen only recently, after the 1996 amendment of section 104(a)(2). We do not need to worry about other hypothetical horrors, or to tear the income tax up by its roots, to get the treatment of this particular item right.

⁴²⁵ Treasury had initially treated a recovery for pain and suffering as taxable, see *supra* note 414 and accompanying text, but we would expect Treasury to be aggressive in defining income.

⁴²⁶ Sol. Op. 132, 1-1 C.B. 92, 93 (1922); see also *supra* notes 233-37 and accompanying text.

⁴²⁷ *Hawkins v. Comm'r*, 6 B.T.A. 1023, 1025 (1927), *acq.*, 7-1 C.B. 14 (1928).

⁴²⁸ See *supra* text accompanying notes 12-15.

⁴²⁹ See Caron, *supra* note 8, at 87-88.

D. Involuntariness and “Personal” Rights

Many of the factual situations in the old cases and rulings discussed in Part V, especially those for victims of persecution, are unlikely to recur, or so one hopes. And most, if not all, of those cases and rulings presented sympathetic sets of facts. Terrible things had happened to people, and it would have been unseemly to sic revenue officials on someone who had suffered from Nazi oppression and was belatedly receiving some “compensation.”

One might argue that sympathy should have little role to play in interpreting taxing statutes. Ms. Murphy, after all, has received no sympathy from commentators, even though she was harmed for exercising protected rights.⁴³⁰ But many cases involve factual situations that evoke sympathy for a reason that has historically been deemed important in characterizing recoveries: the harms were not attributable to voluntary arrangements. The losses being compensated for—of “personal” rights—were arguably unlike those from a business or investment transaction.

Many reasonable folks, including judges, have seen an important difference between a recovery for invasion of privacy, say, and amounts received for selling one’s life story—a difference that might justify different results under Code section 61 and that might have been accepted by drafters of the Sixteenth Amendment. If one voluntarily relinquishes one’s right to privacy for cash, one has income. In contrast, if privacy is involuntarily invaded and the victim is compensated, the result is not so clear, except for any lost-income component of the recovery—which is what the 1996 amendments to section 104(a)(2) were directed at.

Professor Germain refers to Ms. Murphy’s “transaction,”⁴³¹ but that terminology would strike people who are not tax professionals as odd. And it is terminology that is result-driven: we are going to treat this event like Joe and Bob signing a contract—just another tax happening.

Professor Dodge has argued that “[i]nvoluntariness may be a legitimate rationale for deferral of income or perhaps deductibility of outlay, but not for total and permanent exclusion of a clearly realized accession to wealth.”⁴³² Not everyone would agree, however,

⁴³⁰ Ms. Murphy had engaged in protected whistleblower activity. See *Murphy I*, 460 F.3d at 81.

⁴³¹ Germain, *supra* note 29, at 192 (“Ms. Murphy engaged in a transaction when she exchanged her emotional distress damages for cash.”); see also *Murphy II*, 493 F.3d 170, 185 (D.C. Cir. 2007) (rejecting Ms. Murphy’s formulation that the receipt of an award in lieu of lost mental health or reputation is not a “transaction”), *cert. denied*, 553 U.S. 1004 (2008).

⁴³² Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 6, at 183–84.

certainly not when a personal right has been converted. (Indeed, many would question whether there has been “a clearly realized accession to wealth” in a personal injury case with no recovery of lost profits.) In some circumstances, the technical language of taxation does not do an adequate job.

We are talking doctrine here, not grand theory. I think grand theory can distinguish between voluntary and involuntary situations, but, even if grand theory suggests otherwise, the distinction has an intuitive appeal that can shape doctrine. The rulings directed at losses from persecution are right on point.⁴³³ Whatever academic commentators think of the importance of voluntariness or the lack thereof—ridicule is a common reaction⁴³⁴—many people on the street would think you crazy if you suggested taxing a recovery of this sort.⁴³⁵

The position set out in Solicitor’s Opinion 132, issued in 1922 and quoted earlier in the discussion of recoveries for alienation of affections, makes eminently good sense:

If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is clear, therefore, that the Government can not tax him on any portion of the sum received.⁴³⁶

One thing we can say for sure: that sort of recovery was not what ratifiers of the Sixteenth Amendment had in mind in permitting an unapportioned tax on incomes. The income tax was intended to be directed at the wealthy, not those who “profited” from being victims of personal injuries. In my research on the Amendment, I found nothing that would indicate an intention to reach personal injury recoveries. And this sort of recovery, with no element of lost profits, is not what Congressmen were thinking about when section 104(a)(2) was amended.

⁴³³ See *supra* Part V.B.2.b.i.

⁴³⁴ In responding to an article of mine, Professor Dodge wrote, “Jensen indignantly disclaims any sympathy with tax protesters, but does not explain how wages are distinguishable from cash recoveries for personal rights, except on the basis of involuntariness.” Dodge, *Jensen’s Missiles*, *supra* note 16, at 132. In short, I made no distinction other than the distinction I made.

⁴³⁵ The Supreme Court had said that “incomes” generally ought to be interpreted in a nontechnical way, “as the word is known in the common speech of men.” See *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99 (1936).

⁴³⁶ Sol. Op. 132, 1-1 C.B. 92, 93 (1922).

The involuntary-voluntary distinction is recognized in many settings throughout tax law,⁴³⁷ but one argument made to counter the significance of the distinction is that Congress has provided a specific relief provision for involuntary conversions of property. The existence of section 1033, it is argued, implies that involuntary events are no less likely than voluntary ones to lead to unhappy tax consequences.⁴³⁸ At best, section 1033 permits deferral, not forgiveness, of gain on involuntary conversion,⁴³⁹ and section 1033 shows, as does section 104(a)(2), that Congress knows how to provide relief when it wants to.

This argument gives more weight to section 1033 than it can bear. We think of section 1033 as a relief provision, and it is that. But the “general rule” of section 1033 is that, if property is converted into money in an amount greater than basis, gain will be recognized.⁴⁴⁰ The relief part of section 1033—applicable if a taxpayer acquires property “similar or related in service or use” within an appropriate period and makes an election⁴⁴¹—is the *exception* to the general rule.

If it were so clear that an involuntary conversion is a taxable event, why was it necessary for Congress to state this in section 1033? Perhaps because, without section 1033, it might not be clear that gain from an involuntary conversion is a “gain[] derived from dealings in property,”⁴⁴² like a “sale or other disposition of property.”⁴⁴³ In any event, the fact that one provision in the Code deals with involuntary transactions of a particular sort cannot mean the distinction between voluntary and involuntary is never to be taken into account otherwise.

⁴³⁷ For example, *United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968), is often interpreted as a forced-consumption case. See *supra* Part V.B.4. Not a lot of “force” was involved, but the case is different from one in which taxpayer’s behavior is totally voluntary. That factor is also used as a justification for the convenience-of-the-employer doctrine. Another example: I noted Professor Geier’s discussion of the significance of *Taft v. Bowers*, 278 U.S. 470 (1929), in developing the concept of basis. See *supra* note 76. One reason the *Taft* Court rejected the donee’s argument that she could not be taxed on appreciation that had occurred while the property was held by the donor was that she “accepted the gift with knowledge of the statute and, as to the property received, voluntarily assumed the position of her donor.” *Taft*, 278 U.S. at 482.

⁴³⁸ Cf. Dodge, *Jensen’s Missiles*, *supra* note 16, at 132 (arguing that no doctrine supports the notion that cash received as result of an involuntary occurrence is excludable apart from statutory exclusions and deferral provisions).

⁴³⁹ Given the way the basis rules have worked at death, see I.R.C. § 1014 (2006), gain can disappear without being taxed. But in theory, gain not recognized under section 1033 is deferred only. See I.R.C. § 1033 (2006).

⁴⁴⁰ See I.R.C. § 1033(a)(2). Indeed, the panel in *Murphy II* cited section 1033 for its general rule. See *Murphy II*, 493 F.3d 170, 185 (D.C. Cir. 2007) (finding Ms. Murphy’s situation akin to an involuntary conversion of assets), *cert. denied*, 553 U.S. 1004 (2008).

⁴⁴¹ I.R.C. § 1033(a)(1).

⁴⁴² I.R.C. § 61(a)(3) (2006).

⁴⁴³ I.R.C. § 1001(a) (2006).

E. Wages and Recoveries for Emotional Distress

Ms. Murphy's recovery was likened by many critics of *Murphy I* as theoretically indistinguishable from wages, and that is how the sky-is-falling commentary got rolling: If an emotional-distress recovery (even one that included no lost-income component) is not income, then wages are not income either. And, if an unapportioned income tax could not reach wages, the tax base would be gutted. Taken seriously, it was argued, *Murphy I* would have led to the death of the income tax. Our livelihoods depend on the income tax, so *Murphy I* must be wrong.

Professor Dodge, for example, has characterized the emotional-distress recovery in *Murphy* as "compensation for having undergone an unpleasant experience, just as wages are compensation for the loss of the psychic benefits of not working."⁴⁴⁴ And elsewhere, in disputing the legitimacy of the "in lieu of" test, he wrote that "[d]amages received for pain and suffering are no different from wages received for [a] dangerous and miserable job."⁴⁴⁵

I do not accept the logical equivalence. I understand that Chicken Little ruffled feathers, but the sky remained in place after she raised her alarm. So too after *Murphy I*. I can distinguish easily between voluntary arrangements, which lead to the payment of wages, and involuntary ones, which lead to the payment of something else.

Yes, as Professor Dodge argues, some employment arrangements that are in form voluntary are hardly that. Someone who is desperate for work might take any job, and the compensation might seem, as a conceptual matter, to fall on the involuntary side of the divide. But form can matter, and, in any event, more than form is involved. Ask the guy going to the lousy job whether he would prefer to be injured and compensated. Maybe you will find an occasional person who will volunteer for an injury, but the prevailing view in our society remains that work is valued—indeed, that work is a central part of being. Most people are satisfied with their jobs, and we should not fashion a generally applicable legal rule on the basis of the unusual case where employment is truly involuntary.

Remember, too, that Ms. Murphy was characterized as really having lost something. Human capital, whatever it is, does not necessarily get used up by working. Professor Germain argues that human capital is "depleted,"⁴⁴⁶ but education does not wear out during

⁴⁴⁴ Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 6, at 417.

⁴⁴⁵ Dodge, *Recoveries for Nonphysical Injuries*, *supra* note 28, at 987.

⁴⁴⁶ See Germain, *supra* note 29, at 192–93 ("The court of appeals in *Murphy* did not provide a theoretical distinction that would allow Congress to tax wages but not emotional

employment. It might become obsolete as time goes by, but that will be true whether a person is employed or not.

1. The Limits of Logic

Even if, at some level, there is logical equivalence between wages and recoveries for emotional distress—something I will concede *arguendo*—it does not follow that the two need to be treated identically for income-tax purposes. No matter how similar the two categories, drafters of the Sixteenth Amendment could have thought the categories had different statuses, and Congress can decide to treat the two differently. We know, without doubt, that wages were considered income for purposes of the Amendment, and we know also that compensation is includable in gross income under section 61 (unless Congress provides otherwise).⁴⁴⁷ That some see logical equivalence does not mean that Congress is required to see that equivalence.

Of course we should try to interpret the Constitution and any statute in as logical a way as possible. If there are uncertainties, we should try to resolve them logically. We should seek to make the pieces fit together coherently, if we possibly can. And in recommending changes in the law, we should roll out logic's full artillery.

But the law need not be logical. I have heard more than one law professor complain about the illogical basis of one statute or another, and the complaints are often valid. A legal provision nevertheless does not lose its force simply because it is klunkier than we would like. As smart as they were, the Founders acted illogically on occasion.⁴⁴⁸ And, as a general matter, Congress has the constitutional power to act illogically.

Sometimes ignoring a statutory provision is necessary because two provisions are so inconsistent that they cannot be simultaneously enforced: one has to prevail (or perhaps one might decide in such a situation that neither should). That sort of situation is not the norm, but it does happen.⁴⁴⁹

distress damages, even though both are recoveries on account of human capital that has been depleted.").

⁴⁴⁷ See I.R.C. § 61(a)(1); see also *supra* note 27.

⁴⁴⁸ Apportionment is a bizarre way to constrain taxation, but it is part of the Constitution. A critic of the rule can argue that application of the rule should be limited, but not ignored.

⁴⁴⁹ See, e.g., *Chickasaw Nation v. United States*, 534 U.S. 84 (2001) (addressing a conflict in the statutory language of the Indian Gaming Regulatory Act, as codified in 25 U.S.C. § 2719(d)(1) (2006)); see also Erik M. Jensen, *Taxation and Doing Business in Indian Country*,

This sort of statutory disconnect does not exist with emotional-distress recoveries and wages. It is not at all inconceivable that those contemplating the Sixteenth Amendment and those drafting the statutory definition of “gross income” might have concluded that wages should be taxed and emotional-distress recoveries should not.⁴⁵⁰ The views of theoreticians are not necessarily codified in the Internal Revenue Code or reflected in the Constitution.

The critics get the starting point wrong. They argue that, because the two are logically identical in their minds, if we conclude that an emotional-distress recovery is not taxable, we would have to conclude that wages are also not taxable.

I would start the analysis at the other end. We know that wages are taxable, and no analysis, logical or mystical, can change that treatment. If we think wages are logically indistinguishable from emotional-distress recoveries (even though the *Murphy* court concluded that no lost-income component existed⁴⁵¹), we might conclude that such recoveries should be taxed.

But no logic would require that we come to that result. Our conclusion might depend on what the draftsmen thought they were doing. And in making that determination, we might very well take into account that a lot of people now, as was true historically, think taxing an emotional-distress recovery is unjustified, particularly if the recovery has no lost-income component.⁴⁵²

2. *Evolving Conceptions of “Income”*

Whatever the merits of logic, it should not be used, without constitutional amendment or action by Congress, to expand the conception of income beyond what has been accepted in the past. It is one thing to determine that an item is logically indistinguishable from another item that has historically fallen outside the definition of income. In that case, no American taxpayer is hurt by the effects of logic.

The original understanding of emotional-distress recoveries is

60 ME. L. REV. 1, 30–41 (2008) (discussing the canons of interpretation as applied by the Supreme Court in *Chickasaw Nation*); Erik M. Jensen, *Chickasaw Nation: Interpreting a Broken Statute*, 97 TAX NOTES 1195 (2002).

⁴⁵⁰ The amendments to section 104(a)(2) clearly meant that a recovery for emotional distress is not automatically excludable. But that need not mean that the recovery is automatically taxable.

⁴⁵¹ *Murphy I*, 460 F.3d at 79, 81 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

⁴⁵² Some think taxing wages is unfair, too, but they are a smaller part of the population. And we *know* that wages were intended to be taxed.

unclear, if such an understanding existed at all. And we know that the history used in *Murphy I* was less than pristine. But we also know there is reason to doubt whether the Sixteenth Amendment was intended to cover such a recovery, and there is reason to wonder whether Congress, in amending section 104(a)(2), intended to make every such recovery taxable if something other than replacing lost income was involved.

If we are unsure, how do we proceed? The critics of *Murphy I* have no doubts on that score. I have many. At a minimum, it is clear to me that young lawyers—old ones too—are being taught by the *Murphy* events to read a statute in a back-asswards way. Find in a change to an exclusion from gross income, section 104(a)(2), an expansion of the basic idea of what constitutes gross income. That is a crazy way to interpret section 61, and we should not encourage anyone to read the Code in that way. Ultimately the taxation of emotional-distress recoveries does not matter very much, except to affected victims and payors of damages, but how Congress writes and how we read the Internal Revenue Code matter a great deal.

As I noted earlier, Professor Dodge has criticized application of the “in lieu of” test:

[O]ne has to enter the realm of theory to claim that a cash receipt should be excluded on the ground that it is a “substitute for” some kind of nonincome, such as the pleasure of normal existence. That kind of argument might be made with respect to pain-and-suffering damages. But it won’t fly in either the positive-law realm or the tax-theory realm. Wages are taxable precisely because the pleasure of leisure (which has no basis) is converted to cash by the exercise of one’s labor.⁴⁵³

No, wages are *not* “taxable precisely because the pleasure of leisure (which has no basis) is converted to cash by the exercise of one’s labor.” Wages are taxable because Congress has provided specifically for that result and has done so in a way that is consistent with constitutional requirements. Wages are taxable not because of theory; they are taxable because of *the law*.

It is often argued that conceptions of “income” in place when the Sixteenth Amendment was ratified should have no effect in understanding constitutional doctrine. Professor Caron does not want to look at the “entrails” of constitutional debates in the late eighteenth

⁴⁵³ Dodge, *Recoveries for Nonphysical Injuries*, *supra* note 28, at 987 (footnote omitted).

century,⁴⁵⁴ and I suspect he is no more enthusiastic about studying 1913 events. We become more sophisticated as time passes—hearing popular radio (involuntarily), I do not believe this, but I will pretend to—and increasing sophistication in our conceptions of income should be reveled in. Should it matter that something we now want to treat as income might not have been understood as such in 1913?⁴⁵⁵ Should we not take economists' increasing sophistication into account?

Yes and no. Of course, we should take new learning into account in presenting new policy proposals. But when it comes to interpreting existing law, I am a skeptic.

It is weird (and maybe unconstitutional?) to permit an “improved” conception of income to *expand* congressional power. We properly interpret the Fourth Amendment as applicable to modern forms of electronic surveillance, although (obviously) unknown in 1789, but we do so to *limit* governmental power. It is fundamentally different to use our sophisticated understanding of taxation to contract a constitutional limitation and thus to expand congressional power.

It is particularly perverse to delegate constitutional interpretation to academic theorists. The Constitution should not be amended in faculty lounges. “Income within the meaning of the Sixteenth Amendment,” wrote the Supreme Court in 1936, is “[w]ith few exceptions, if any, . . . income as the word is known in the common speech of men.”⁴⁵⁶ Academics in Hyde Park or Cambridge might understand “income” better than their predecessors did fifty years ago, but improved understanding does not translate into law.

Within constitutional boundaries, Congress can define income as it wishes, but it should do so explicitly. Despite the omnipresent language to the effect that Congress in section 61 meant to exercise the full complement of its taxing power, that has never been the case—Congress has provided many exclusions⁴⁵⁷—and it has never been understood to be the case, as cases like *Gotcher* illustrate.⁴⁵⁸

⁴⁵⁴ See *supra* note 122 and accompanying text.

⁴⁵⁵ Folks in 1913 had not thought of all issues that occupy us today, but they were not stupid. Might imputed income be taxable? Instructions for the first modern tax return say a homeowner shall not be “required to include . . . estimated rental [value] of his home as income.” INTERNAL REVENUE SERVICE, FORM 1040: RETURN OF ANNUAL NET INCOME OF INDIVIDUALS 4, at Instruction 10 (1913), *available at* www.irs.gov/pub/irs-utl/1913.pdf; see also *id.* at Instruction 17 (“Estimated advance in value of real estate is not required to be reported as income, unless the increased value is taken up on the books of the individual as an increase of assets.”).

⁴⁵⁶ *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99 (1936).

⁴⁵⁷ See I.R.C. §§ 101–39A (2006) (identifying items specifically excluded from gross income).

⁴⁵⁸ See *supra* Part V.B.4.

Congress did not expand the potential scope of section 61 by narrowing the exclusion in section 104(a)(2),⁴⁵⁹ and we should not interpret the congressional act as doing more than it was intended to do: to make taxable recoveries for lost profits or wages.

Academic theorists might respond that the full amount of a recovery for alienation of affections, or some other nonphysical injury, ought to be taxed, for reasons A and B, and those reasons might be respectable. Maybe the recovery is arguably a windfall, or conceptually the conversion of a zero-basis asset. Or maybe it is in theory indistinguishable from wages. The theorists might even be able to convince me that, on the merits—if we were building a tax system from scratch—there would be no justification for excluding a particular recovery.

But that is not the way a practitioner ought to be thinking (and academics ought not to be teaching their students to look only for conceptually pure results). Congress sometimes *intends* to adopt a position that is conceptually impure, and nothing in the Constitution requires Congress to conform to currently prevailing norms in the academy.

VII. *MURPHY II*: THE DO-OVER

The original D.C. Circuit panel, after a petition for rehearing en banc had been filed, but before it had been acted upon, vacated the decision in *Murphy I* and scheduled the case for reargument.⁴⁶⁰ When it reconsidered *Murphy*, the panel—with institutional face blushing—decided several important issues differently and came to a diametric result.⁴⁶¹

The panel might very well have been “prodded by the tax blogosphere,”⁴⁶² as Professor Caron suggested, but the result is not a strong endorsement for blogging. In fact, the state of the law might be worse after *Murphy II* than if *Murphy I* had been left untouched. Indeed, because of the way the panel pretended it was responding only to new arguments, the untouched parts of *Murphy I* are still relevant, even if not authoritative.

Because *Murphy I* had been withdrawn, the opinion in *Murphy II* generally reads as if the court were hearing the case for the first time. The panel did note the result in *Murphy I*, but then acted as if it were proceeding anew because the government raised a new argument

⁴⁵⁹ But see *infra* Part VII (discussing the decision in *Murphy II*).

⁴⁶⁰ See *Murphy v. IRS*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

⁴⁶¹ *Murphy II*, 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008).

⁴⁶² Caron, *supra* note 8, at 91.

“belatedly”: that the Sixteenth Amendment was irrelevant if the tax on the recovery was not a direct tax.⁴⁶³

The panel dealt with three questions in *Murphy II*. First, was the tax imposed on Ms. Murphy within the power granted to Congress under the Taxing Clause?⁴⁶⁴ Despite what the panel had said in *Murphy I*, the answer was yes⁴⁶⁵—and quite appropriately so. It does not matter if the emotional-distress recovery was not “income” as traditionally understood. Congress can call an excise an “income tax” if it wishes, so long as it has authority to impose the excise. On that point, the panel quoted from the Third Circuit’s 1960 decision in *Penn Mutual Indemnity Co. v. Commissioner*⁴⁶⁶: “Congress has the power to impose taxes generally, and if the particular imposition does not run afoul of any constitutional restrictions then the tax is lawful, call it what you will.”⁴⁶⁷ The real constitutional questions in *Murphy* had to do with application of the apportionment rule, not whether an emotional-distress recovery could be taxed at all.

Question 2: If the levy was permitted under the Taxing Clause, was it nevertheless a direct tax required to be apportioned?⁴⁶⁸ Here the panel concluded that the tax was not direct, no apportionment was required, and the meaning of “incomes” in the Sixteenth Amendment—the key issue in *Murphy I*—was irrelevant.⁴⁶⁹ I am sympathetic to the constraints the panel was under, given the mass of unprincipled authority, but I question that conclusion in Part VII.A.

The panel concluded in *Murphy I* that the tax on the emotional-distress recovery was not a “tax on incomes.”⁴⁷⁰ The panel in *Murphy II* said it was dealing with “new” arguments, but no new argument called that determination into question.⁴⁷¹ *Murphy I* has technically disappeared, but we might assume that the panel continued to believe the levy was not on “incomes” within the meaning of the Amendment.⁴⁷² That brings us to question 3: Could the levy, incorporated in the income-tax provisions of the Internal Revenue Code, reach the recovery if it was not “income” in a constitutional sense? Or, to put the question another way, could the

⁴⁶³ See *Murphy II*, 493 F.3d at 173.

⁴⁶⁴ See *id.* at 180–86.

⁴⁶⁵ *Id.* at 186.

⁴⁶⁶ 277 F.2d 16 (3d Cir. 1960).

⁴⁶⁷ *Murphy II*, 493 F.3d at 179 (quoting *Penn Mutual*, 277 F.2d at 20).

⁴⁶⁸ See *id.* at 181.

⁴⁶⁹ *Id.* at 181–86.

⁴⁷⁰ See *Murphy I*, 460 F.3d 79, 88 (D.C. Cir.), *vacated*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22).

⁴⁷¹ See *Murphy II*, 493 F.3d at 173.

⁴⁷² If the tax was on “incomes,” the rest of the discussion in *Murphy II* was unnecessary.

concept of "income" in section 61's definition of "gross income" be *broad*er than the meaning of "incomes" in the Sixteenth Amendment?⁴⁷³ The panel answered that question affirmatively.⁴⁷⁴ I question that conclusion in Part VII.B.

A. Was the Tax Direct?

The *Murphy II* panel could ignore the meaning of the Sixteenth Amendment, the decisive issue in *Murphy I*, because it concluded that the levy on an emotional-distress recovery was not a direct tax.⁴⁷⁵ For an indirect tax, the apportionment rule and the Amendment are irrelevant.

Looking at case law over the decades, and noting the obvious ("cases have not definitively marked the boundary between taxes that must be apportioned and taxes that need not be"⁴⁷⁶), the panel stated, "[o]nly three taxes are definitely known to be direct: (1) a capitation, (2) a tax upon real property, and (3) a tax upon personal property."⁴⁷⁷ Even though the Supreme Court had concluded in *Pollock* that a tax on income from property is direct, the panel questioned "[w]hether that portion of *Pollock* remains good law."⁴⁷⁸ "That portion" of *Pollock* is the core of the case, and one wonders why a panel that felt "instructed" to follow Supreme Court precedent on many other points was doubtful about this one.⁴⁷⁹

On drawing the line between direct and indirect taxes, the panel properly rejected the government's argument that only "taxes that are capable of apportionment in the first instance, specifically, capitation

⁴⁷³ See 493 F.3d at 176.

⁴⁷⁴ *Id.* at 181.

⁴⁷⁵ *Id.* at 186.

⁴⁷⁶ *Id.* at 181.

⁴⁷⁷ *Id.* (citation omitted).

⁴⁷⁸ *Murphy II*, 493 F.3d at 181 n.**.

⁴⁷⁹ See *supra* notes 387–404 and accompanying text (discussing issues the panel was "instructed" on). Some cases have been overruled without a definitive statement. The Court in *Brown v. Board of Education*, 347 U.S. 483 (1954), did not expressly overrule *Plessy v. Ferguson*, 163 U.S. 537 (1896); it "rejected" statements contrary to "modern [psychological] authority," *Brown*, 347 U.S. at 494–95, and "conclude[d] that in the field of public education the doctrine of 'separate but equal' has no place." *Id.* at 495. But many cases have said *Brown* overruled *Plessy*. See, e.g., *Planned Parenthood of S.E. Pa. v. Casey*, 505 U.S. 833, 864 (1992) (plurality opinion of O'Connor, Kennedy & Souter, JJ.); *id.* at 960 (Rehnquist, C.J., White, Scalia & Thomas, JJ., concurring in judgment in part and dissenting in part). Nothing like that has happened with *Pollock*. One part of the case was explicitly rejected, with no implication the entire case had to fall. See *supra* note 124 (discussing *South Carolina v. Baker*, 485 U.S. 505 (1988)). The government argued in *Murphy II* that, "although [*Pollock*] has never been overruled, 'every aspect of its reasoning has been eroded,'" *Murphy II*, 493 F.3d at 183 (citing *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112–13 (1916)), but the panel cited post-*Stanton* cases in a way that made it impossible to accept *Pollock*'s complete demise.

taxes and taxes on land,' are direct taxes."⁴⁸⁰ That interpretation would make the direct-tax apportionment rule, at least "[i]n the abstract, . . . no constraint at all."⁴⁸¹

But the panel was also unwilling to adopt the principled distinction between direct and indirect taxes outlined earlier in this Article, and instead looked primarily to whether the incidence of the tax can be shifted to someone else and whether, as a result, the typical taxpayer is able to avoid the tax if he wishes.⁴⁸² Murphy had made this argument about original understanding, and the panel seemed sympathetic.⁴⁸³ But, faced with Supreme Court authority characterizing a multitude of levies as indirect, the panel—again deferring to Court precedent⁴⁸⁴—was inevitably going to conclude that the tax on the emotional-distress recovery was indirect.

The case law on direct taxation from the nineteenth and early twentieth centuries had developed with *Hylton* as controlling authority, and, except for the income tax at issue in *Pollock*,⁴⁸⁵ the Court had characterized no levy as direct. The *Murphy II* panel wrote that

Murphy makes no attempt to reconcile her definition with the long line of cases identifying various taxes as excise taxes, although several of them seem to refute her position directly. In particular, we do not see how a known excise, such as the estate tax, or a tax upon income from employment [citing *Pollock*], can be shifted to another person, absent which they seem to be in irreconcilable conflict with her position that a tax that cannot be shifted to someone else is a direct tax. Though it could be argued that the incidence of an estate tax is inevitably shifted to the beneficiaries, we see at work none of the restraint upon excessive taxation that Murphy claims such shifting is supposed to provide; the tax is triggered by an event, death, that cannot be shifted or avoided. In any event, [*Knowlton v. Moore*] addressed the argument that *Pollock I* and *II* made ability to shift the hallmark of a direct tax, and rejected it.⁴⁸⁶

⁴⁸⁰ *Murphy II*, 493 F.3d at 182 (citing Johnson, *Constitutional Absurdity*, *supra* note 92, at 314 (2004)).

⁴⁸¹ *Id.* at 184.

⁴⁸² *Id.* at 182–84.

⁴⁸³ *See id.* at 184.

⁴⁸⁴ *Cf. supra* notes 387–404 and accompanying text.

⁴⁸⁵ Later cases like *Macomber* assumed that an income tax is direct.

⁴⁸⁶ *Murphy II*, 493 F.3d at 184 (citations omitted) (citing *Knowlton v. Moore*, 178 U.S. 41,

Unable to rely on first principles, the panel thought it was required to determine “whether the tax laid upon Murphy’s award is more akin, on the one hand, to a capitation or a tax upon one’s ownership of property, or, on the other hand, more like a tax upon a use of property, a privilege, an activity, or a transaction.”⁴⁸⁷ With the field tilted in this way, the result was foreordained: “Regardless what the original understanding may have been, . . . we are bound to follow the Supreme Court, which has strongly intimated that Murphy’s position is not the law.”⁴⁸⁸

A tax on ownership? No, the levy was not on Murphy’s ownership of human capital.⁴⁸⁹ On a transaction? Yes. Murphy said no transaction had taken place, but this was like an involuntary conversion of human capital, and involuntary conversions are generally taxable events.⁴⁹⁰ No profit may have been involved—that was determined in *Murphy I*—but whether there has been an “accession to wealth” matters only in determining if a tax is on “incomes.”⁴⁹¹ Like a tax on a privilege? Yes, Murphy used the legal system to secure her recovery, and the tax was like an excise permitting access to a commodities exchange.⁴⁹²

Say what? *This levy was an excise on the use of the legal system?* I can refute none of these points directly because there is no principle underlying any of them, except that the apportionment rule should apply to little or nothing. I understand why the panel thought it had to proceed as it did, given an incoherent body of case law, but the result is crazy.

What in fact was Murphy taxed on? If we ignore the question as to whether the \$70,000 was income or not, she was not taxed because

81–82 (1900)). The *Knowlton* Court said only that the *Pollock* Court had not *relied* on whether the tax could be shifted. *Knowlton*, 178 U.S. at 82. But it is true the Court did not view ability to shift as a defining characteristic of an indirect tax.

⁴⁸⁷ *Murphy II*, 493 F.3d at 184.

⁴⁸⁸ *Id.*

⁴⁸⁹ *Id.* (“Even if we assume one’s human capital should be treated as personal property, it does not appear that this tax is upon ownership; rather, as the Government points out, Murphy is taxed only after she receives a compensatory award, which makes the tax seem to be laid upon a transaction.”).

⁴⁹⁰ See I.R.C. § 1033 (2006).

⁴⁹¹ “Whether she profited is irrelevant . . . to whether a tax upon an award of damages is a direct tax requiring apportionment; profit is relevant only to whether, if it is a direct tax, it nevertheless need not be apportioned because the object of the tax is income . . .” *Murphy II*, 493 F.3d at 185.

⁴⁹² *Id.* at 186 (“[T]he facility used in [*Nicol v. Ames*, 173 U.S. 509 (1899)] was a commodities exchange whereas the facility used by Murphy was the legal system, but that hardly seems a significant distinction. The tax may be laid upon the proceeds received when one vindicates a statutory right, but the right is nonetheless a ‘creature of law,’ which [*Knowlton v. Moore*, 178 U.S. 41 (1900)] identifies as a ‘privilege’ taxable by excise.”).

she had participated in a transaction, engaged in an activity, or had been afforded the “privilege” of being able to participate in the legal system. *She was being taxed because she had \$70,000 in cash.* Is that not a tax on ownership?

B. Was Murphy’s Recovery Includable in Gross Income?

The constitutional issues matter only if the \$70,000 would have been reached statutorily. In *Murphy II*, the panel concluded that, whether or not the recovery was “income” within the meaning of the Sixteenth Amendment, Congress intended to include an emotional-distress recovery in “gross income,” as defined in Code section 61, when it amended section 104(a)(2).⁴⁹³ Whether the recovery was also “incomes” under the Amendment disappeared as an issue because the D.C. Circuit panel concluded the levy was an excise exempt from apportionment.⁴⁹⁴

Although the *Murphy I* panel had noted the long-time understanding that the term “income” should be interpreted similarly for statutory and constitutional purposes, in *Murphy II* the panel reversed direction: “‘Gross income’ in § 61(a) is *at least as broad* as the meaning of ‘incomes’ in the Sixteenth Amendment,”⁴⁹⁵ and therefore potentially broader. It did not matter that in *Murphy I* the panel had concluded the recovery was not “incomes” within the meaning of the Amendment, and that nothing—no “new” argument—had changed that result.

That was an astonishing conclusion, backed by astonishing reasoning. Step one was the statutory argument. Although it was unclear whether the recovery would have been covered by section 61 before 1996—is there an “accession to wealth” with only a return of capital?⁴⁹⁶—the amendments to section 104(a)(2) effectively amended section 61. Judge Ginsburg admitted that, “[l]ooking at § 61(a) by itself, one sees no indication that it covers Murphy’s award unless the award is ‘income’ as defined by *Glenshaw Glass* and later cases.”⁴⁹⁷ But the boundaries of section 61 had to be understood as changed by the amendment to section 104(a)(2).⁴⁹⁸ Congress intended to tax a

⁴⁹³ *Id.* at 176.

⁴⁹⁴ *See id.* at 185.

⁴⁹⁵ *Id.* at 176 (emphasis added).

⁴⁹⁶ The “return of capital” material from *Murphy I* was not rejected in *Murphy II*. *See id.* at 185.

⁴⁹⁷ *Id.* at 179.

⁴⁹⁸ “For the 1996 amendment . . . to ‘make sense,’ gross income . . . must . . . include an award for nonphysical damages such as Murphy received, regardless whether the award is an accession to wealth.” *Id.* at 180.

recovery like Murphy's, and, even though it did not take the appropriate steps to amend section 61, Congress's intentions should be effectuated. Read section 61 in conjunction with section 104(a)(2) and, *voile!*, we have gross income.

Much is wrong here. For one thing, Judge Ginsburg wrote that this reading—Congress broadened section 61's application without amending section 61—is necessary because the 1996 amendment, "which narrows the exclusion, would have no effect whatsoever if such damages were not included within the ambit of § 61."⁴⁹⁹ Some commentators have made this argument as well,⁵⁰⁰ but it is wrong. The amendment was intended to make taxable a recovery for lost profits, and it did that for nonphysical personal injuries—a significant effect by itself. It does not follow that a recovery for something other than lost profits was picked up.

It is probably true that congressmen thought they were broadening the definition of gross income to include any recovery for a nonphysical personal injury. But, as I discussed earlier, that could not possibly have been the result of the statutory change unless Congress meant to gut many preexisting understandings, including the ability to recover basis tax-free.⁵⁰¹

C. Can "Gross Income" Be Broader Than "Incomes"?

Step two is the constitutional component of the argument. Although this addition to "gross income" might not be "incomes" within the meaning of the Sixteenth Amendment, that does not matter if the levy is an excise. And the panel had determined that no direct tax was involved.⁵⁰² If Congress defines "gross income" to impose a permissible excise—an indirect tax not subject to apportionment—no harm is done by calling the taxed item *income*. Furthermore, if the tax on this enlarged conception of gross income is indirect, no apportionment is required *even if this is not income within the meaning of the Amendment—even, that is, if there is no accession to wealth*.⁵⁰³ In fact, the result was "so clear," wrote Ginsburg, "that we

⁴⁹⁹ *Id.* at 179.

⁵⁰⁰ See, e.g., Germain, *supra* note 29, at 208; see also *supra* note 186.

⁵⁰¹ See *supra* Part V.B.1.

⁵⁰² See *supra* Part VII.B.

⁵⁰³ In a footnote, the panel noted the heading in the legislative history that read, "Include in income damage recoveries for nonphysical injuries." *Murphy II*, 493 F.3d at 179–80 n.* (quoting H.R. REP. NO. 104-586, at 143–44 (1996), reprinted in 1996-3 C.B. 331, 481–82); see also *supra* notes 188–91 and accompanying text. The panel concluded: "For the 1996 amendment of § 104(a) to 'make sense,' gross income in § 61(a) must, and we therefore hold it does, include an award for nonphysical damages such as Murphy received, regardless whether the award is an accession to wealth." *Murphy II*, 493 F.3d at 179 n.*.

have no occasion to apply the canon favoring the interpretation of ambiguous revenue-raising statutes in favor of the taxpayer.”⁵⁰⁴

Well. Does it make sense to think that Congress meant to tear apart the connection between the meaning of “income” in the Internal Revenue Code and the Constitution? If Congress did not mean to do that, does it make sense to interpret a statute in a way that leads to a counterintuitive result? Are we now to assume that what is called an “income tax” in the Code need bear no relationship to what is considered an income tax for other purposes?

Professor Dodge is persuasive on these points. He agrees that, if the levy in *Murphy* was indirect, then Congress could have reached the emotional-distress recovery as part of an unapportioned tax.⁵⁰⁵ But the issue of constitutional validity arises only if the levy is authorized by the Code. The statutory definition of gross income includes fifteen enumerated items, none of which includes a personal injury recovery.⁵⁰⁶ The statutory authority to reach this recovery therefore must be the catch-all provision “income from whatever source derived.”⁵⁰⁷ The recovery must be “income” if it is to be reached by section 61.⁵⁰⁸

As Dodge argues, “If ‘income’ in the catch-all clause of section 61 were construed to include *anything* that Congress *could* tax as an indirect tax, then it would no longer mean ‘income,’ but something broader and perhaps indeterminate.”⁵⁰⁹ And interpreting the statutory change in this way would treat Congress as having legislated something it did not legislate.

To be sure, Judge Ginsburg provided a partial answer to this conundrum:

Principles of statutory interpretation could show § 61(a) includes Murphy’s award in her gross income regardless whether it was an “accession to wealth” For example, if § 61(a) were amended specifically to include in gross income “\$100,000 in addition to all other gross income,” then that additional sum would be a part of gross income under § 61 even though no actual gain was associated with it. In other words, although the “Congress cannot make a thing income which is not so in fact,” it can *label* a thing income

⁵⁰⁴ *Murphy II*, 493 F.3d at 179.

⁵⁰⁵ Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 6.

⁵⁰⁶ See I.R.C. § 61(a) (2006).

⁵⁰⁷ *Id.*

⁵⁰⁸ See Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 6, at 375.

⁵⁰⁹ *Id.*

and tax it, so long as it acts within its constitutional authority [R]ather than ask whether Murphy's award was an accession to her wealth, we go to the heart of the matter, which is whether her award is properly included within the definition of gross income in § 61(a), to wit, "all income from whatever source derived."⁵¹⁰

I will concede *arguendo* that Judge Ginsburg's example could expand the definition of "gross income" beyond the boundaries of the Sixteenth Amendment. If Congress amends section 61 in such a way that it clearly intends to pick up items that are not accessions to wealth, so be it (although it would be a bad idea), as long as Congress has other authority for the tax.

But Judge Ginsburg's example is nothing like what happened in 1996. Congress did not amend section 61 to include something that previously had not been within the catch-all provision, "income from whatever source derived." Congress left section 61 intact, and the careful statute-reader would have no reason to know that the boundaries of section 61 had been expanded. We should not encourage congressional sloppiness by reading more into statutory language than it can encompass, particularly when the effect is to expand the scope of taxation.

The example was flawed for an even more fundamental reason: Ginsburg was making the case that Congress could impose an unapportioned tax on an emotional-distress recovery whether or not it was on "incomes." But Congress has no obvious authority to impose an unapportioned tax on the hypothesized \$100,000. If not an accession to wealth, the \$100,000 is not income as traditionally understood. And if the tax is not on income, it is hard to see the tax as anything but on ownership of property. The time-honored understanding is that a tax on property is direct,⁵¹¹ and, if the levy is direct and has not been properly apportioned, it is unconstitutional.

The *Murphy* panel likened a tax on an emotional-distress recovery to one on a privilege. I am unconvinced—characterizing the levy as on the privilege of using the legal system is absurd—but at least an effort was made. With his hypothetical, however, Judge Ginsburg did not explain how a levy on \$100,000 is like any judicially blessed

⁵¹⁰ *Murphy II*, 493 F.3d at 179 (citation omitted) (quoting *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925)).

⁵¹¹ Taxes on real estate, the main component of wealth in the eighteenth century, were clearly understood to be direct, and a wealth tax today should be treated similarly. See Jensen, *Meaning of Incomes*, *supra* note 19, at 1128–29. But see Ackerman, *supra* note 139, at 58 (arguing for the constitutionality of an unapportioned wealth tax); Johnson, *Purging Out Pollock*, *supra* note 138 (ditto).

indirect tax. Judge Ginsburg gave an example of an unapportioned *direct* tax to illustrate the constitutionality of taxing Murphy's recovery!

I come to the same conclusion with Murphy's situation. If the levy was not on gross income, as traditionally understood, and Congress did not structure the levy in a way similar to accepted excises, Congress must have been imposing a tax on the \$70,000. If that was not an accession to wealth, or something similar—if, that is, it was not "incomes"—the levy was a tax on property, and, because unapportioned, an invalid direct tax.

As bad as the howlers in *Murphy I* were, *Murphy II* was in some respects worse. It seemed to validate the idea of an unapportioned tax on wealth—something that had not been accepted before.

VIII. CONCLUSION

I have an admission: I do not care whether emotional-distress recoveries are reached by the income tax. In the vast majority of cases, there will be little to argue in support of exclusion anyway. Recovery of lost profits? Clearly taxable. I am convinced that such a levy would be treated as "on incomes" for constitutional purposes, and I have no doubt that every important court would come to the same conclusion. And maybe, when push comes to shove, I could be convinced that Ms. Murphy, even though she was deemed to have recovered nothing for lost wages, still had no strong arguments in support of excluding most or all of her recovery.

But we should still care how we think about these matters in general, and a lot of overkill has been used in condemning *Murphy I*. Whatever the merits of the result in that case, we should not be proceeding on the assumption that a recovery for a nonphysical personal injury is automatically taxable. It is not. Generally yes, always no.

Whatever an economist might think, distinctions between voluntary and involuntary events, and between market transactions and undesired damage to personal rights, are reasonable factors to take into account in distinguishing between taxable and nontaxable events. And, whether they are reasonable or not in the minds of modern theorists, constitutional and statutory draftsmen could have had them in mind. Life would have gone on quite well—the income tax would not have imploded—if *Murphy I* had remained on the books.

Finally, we should question the extraordinary expansion of the taxing power that *Murphy II*, if taken seriously, seems to permit. The

D.C. Circuit panel did not mean to do this (and we should read the opinion with that understanding), but *Murphy II* can be read as support for an unapportioned tax on wealth. There are those in the academy who have argued for such a tax,⁵¹² and the world would not come to an end if it were permitted. But we should not fool ourselves that an unapportioned wealth tax was understood, outside academic quarters, to be permissible under the Constitution as ratified, or as amended by the Sixteenth Amendment—until now.

⁵¹² See, e.g., Ackerman, *supra* note 139, at 58; BRUCE ACKERMAN & ANNE ALSTOTT, *THE STAKEHOLDER SOCIETY* (1999).